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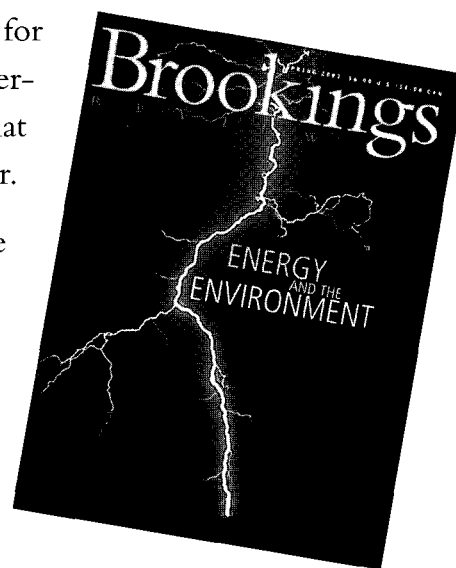
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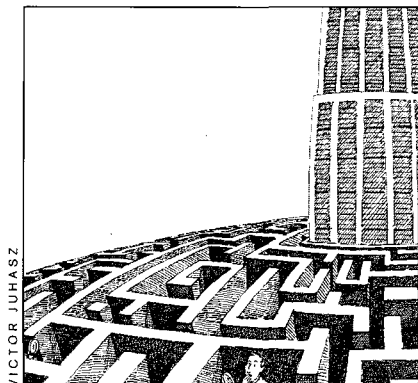


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Powerful as it is, the United States cannot address many of today's gravest challenges without joining hands with governments and citizens of other nations. Infectious diseases know no national boundaries, and combating them has long required governments to work together. Likewise, air pollution can be efficiently reduced only through international cooperation. The financial crises that have rocked various emerging market countries have necessitated international financial rescues. Most immediately, the global terrorist threat compels governments the world over to gather intelligence and apprehend terrorists before they strike, as well as attempt to coordinate necessary diplomatic, military, and humanitarian responses.

GOVERNANCE IN AN INTEGRATED Global ECONOMY

By Carol Graham and
Robert E. Litan

All these challenges are increasingly shaped by "globalization"—the increasing integration of economies and peoples of different countries. In some ways globalization facilitates meeting global challenges because integration creates constituencies within countries that want to solve problems at a supranational level. But at the same time, cross-border integration itself is difficult, if not impossible, for governments to manage or govern.

Nonetheless, govern we must—or at least attempt to do so. The time could not be bet-

ter, therefore, for Brookings to examine—through articles in this *Review*—how the United States should, or even must, work with other governments to meet challenges that confront us all. Daniel Kaufman has defined governance at the national level as the exercise of authority through formal and informal traditions and institutions for the common good. While the same definition underlies the concept of global governance, its application is much more complex across national borders. In addition, the size and diversity of actors involved are far greater.

Nongovernment actors, for example, play an increasingly important role in economic issues of global concern, as do cross-national standards and codes of conduct. Standards of corporate responsibility in the United States

not only affect the operations of our firms at home and abroad but also influence the conduct of business in other countries, particularly those where regulatory capacity is weak. And the private sector, which has traditionally played a strong role in activities relating to the public good in the United States, is becoming a critical player in debates on international economic development and public health policy.

The articles that follow identify some of the most important trends and challenges that require multinational attention, and, where possible, propose strategies for better managing the process. Ann Florini, for example, addresses the issue of standards of cross-border corpo-

rate conduct. In the absence of effective international regulation to protect workers, communities, and the environment, she explains, the fight over the place of business in global governance is occurring largely in the realm of corporate codes of conduct—some vague, some specific and subject to external monitoring and verification. Will these codes of conduct work?

Ngaire Woods explores how the structure of government representation in the International Monetary Fund and World Bank affects—for the worse—their accountability.

Carol Graham is vice president and director of the Brookings Governance Studies program. Robert E. Litan is vice president and director of the Brookings Economic Studies program.

Decades ago, when the functions of both institutions were narrow and technical, their accountability was of less moment. But today their work affects huge numbers of people, as well as sectors beyond the economy, in developing countries. Without a major change in governance, the IMF and the Bank may have to be reined in from activities for which they are not sufficiently accountable.

Jean Lanjouw focuses on the costly and bitter decade-long dispute between the pharmaceutical industry and advocates for the poor over patent protection in developing countries. Lanjouw offers an innovative proposal for a patent system that recognizes differences in countries' well-being and, at the same time, encourages the private sector to become involved in creating new drugs for diseases endemic to the developing world.

Thorsten Benner, Wolfgang Reinicke, and Jan Martin Witte explore how technological change and economic and political liberalization have transformed and complicated conditions for international governance. To respond to a wide range of contemporary challenges—the environment, AIDS, corruption—participants from civil society, business, international organizations, and governments are joining forces in an experimental form of governance known as global public policy networks.

Nancy Birdsall posits that while not all the suspicions of antiglobalization activists are warranted, the activists are correct in asserting that opportunities in the global economy are not equal. When the global market works, it often leaves behind those without adequate training and material assets. When the global market fails, it is most costly for the already weak and disadvantaged. Unlike the rich and powerful, the poor cannot design and implement global rules to their own advantage. Birdsall calls for an improved global polity, in which more democratic representation of poor countries in managing the global economy mediates the downside of global markets.

Shang-Jin Wei and Heather Milkiewicz posit that the insider trading and shady bookkeeping that brought down Enron

and other big U.S. businesses—and triggered huge losses on Wall Street—also weaken stock markets abroad, decreasing investment worldwide. They advocate close regulation of financial markets to prevent fraudulent and illegal corporate practices.

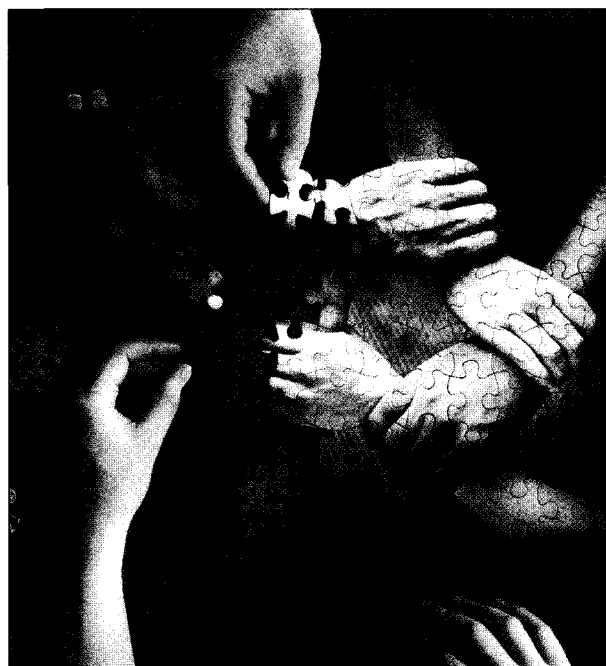
Michael Kremer and Seema Jayachandran note that in most countries, individuals do not have to repay money that others fraudulently borrow in their name. But citizens of a dictatorship are obligated to repay any and all of their leader's cross-border debts. If they default, they hurt their chances of attracting foreign investment to get their country back on its feet. Kremer and Jayachandran propose ways to discourage lending to such regimes and to relieve citizens of the obligation to repay debt incurred by an illegitimate regime.

Carol Graham and Sandip Sukhtankar explore how the recent financial crises in Latin America have affected the health of the region's fragile young democracies. Surprisingly, they find, using polling data, that despite the bad economic news, the share of Latin Americans who favor democracy over any other system of government is growing. Though often critical of their own government's performance, many of those polled expressed their preference for democracy as a system of government—and distinguished as well between market policies and the way the market is working in their country.

President Bush's plan to add \$5 billion to U.S. development assistance and create a new program to help the world's poorest countries presents an opportunity to transform U.S. development policy. Lael Brainard shows how the new program, with aid based on economic performance and good government, could create incentives for poor-country governments to improve

both economic policies and governance and to help already strong performers sustain growth and improve investment climates. She also explores the questions that this approach poses for foreign assistance in general.

James Steinberg considers how information technology (IT) can help the world's poorest nations share in the gains of globalization. Early hopes that "wiring the South" would enable developing countries to leapfrog earlier stages of development have been tempered by experience. If IT is to spur growth, it must be part of an overall national strategy for development that brings together all stake-



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holders—government, the local private sector and civil society, and the donor community.

The articles that follow give readers a quick guide to some of the challenges around the world that require both innovative thinking and international cooperation. ■

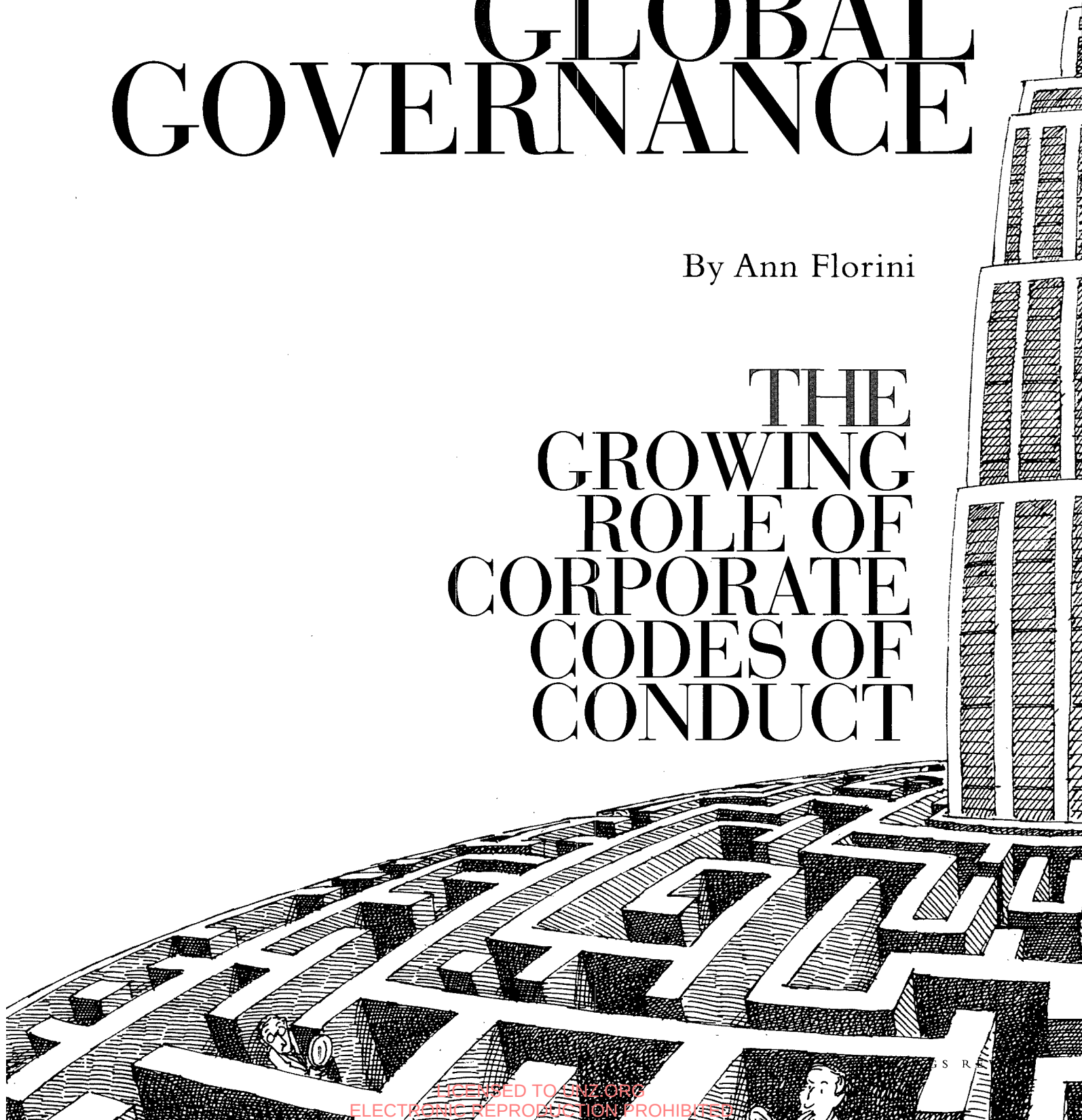
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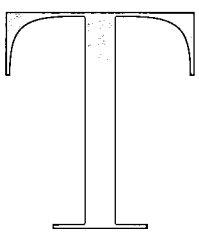
In the article by Stuart Taylor in the winter 2003 issue, the Foreign Intelligence Surveillance Act was, because of an editorial error, incorrectly called the Foreign Intelligence Security Act.

BUSINESS AND GLOBAL GOVERNANCE

By Ann Florini

THE GROWING ROLE OF CORPORATE CODES OF CONDUCT





These are, in many ways, halcyon days for global business. In a vast ideological shift in the late 20th century, markets rather than governments came to be seen as the road to prosperity. Governments that once nationalized foreign firms now seek out the investment, technology, and managerial expertise such companies can bring. The halls of the United Nations used to ring with calls for international regulation of those dreaded evil-doers, the multinational corporations. Now the UN instead implores business to join with it in a voluntary Global Compact to ensure respect for internationally agreed environmental, labor, and human rights standards.

And business has truly gone global. Surging transportation and communications technologies in the past few decades have encouraged firms the world over to cross borders, and revitalized industries in Europe and Japan have offered new competition to U.S. firms. At the beginning of the 1990s, some 35,000 parent multinational corporations had roughly 170,000 foreign affiliates. By the end of the decade, 60,000 parent companies had more than 500,000 foreign affiliates, accounting for a quarter of global output in the late 1990s. As transnationals reorganize the production of goods and services, production itself is becoming global in structure.

But there are clouds on the global business horizon that go beyond the current dour economic climate. The lack of effective international (and often national)

Ann Florini is a senior fellow in the Brookings Governance Studies program. This article is drawn from her new book, The Coming Democracy: New Rules for Running a New World (Island Press, 2003).

regulation to protect workers, communities, and the environment has spurred the development of a powerful movement aimed at promoting corporate social responsibility, whose partisans have on occasion forced significant changes in business practices through campaigns aimed at consumers and investors. And because unregulated business activities can cause societies to question the legitimacy of corporations, corporate leaders themselves are struggling with fundamental questions about how far their social responsibilities extend: to shareholders, employees, local communities where they operate, humanity as a whole, future generations?

National Regulation?

Repeated efforts, starting with the proposed International Trade Organization in the 1940s, to create internationally agreed rules to regulate cross-border business have all failed. Regulation of these firms thus falls to national governments. But governments are often finding it difficult to cope. Mega-companies' huge resources dwarf those of national prosecutors, making legal control a challenge. Changes in the ways global corporations produce goods also complicate national regulation. Companies both big and small contract out with suppliers in far-flung parts of the world—Disney reputedly has some 300,000 separate suppliers. A company with a brand name such as Levi Strauss or WalMart effectively controls a long chain of frequently shifting suppliers based primarily in low-wage countries, thus controlling much of what suppliers do: what product quality standards and schedules must be met, what products will be produced. But for the most part, control over such matters as working conditions in and environmental spillovers from those suppliers' facilities remains in the hands of the national governments where suppliers are located. Because enforcement of labor and environmental standards in those low-wage countries is often, to put it mildly, less than fully effective, this pattern of production enables rich-country firms to reap the benefits of low production costs without having to pay attention to the associated social costs.

Even in countries with well-established regulatory systems and

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effective courts, a determined company can flout the law. Some get caught, but only after doing extensive damage. Louisiana-Pacific Corporation was recently assessed the largest criminal fine in the 28-year history of the U.S. Clean Air Act. The company, which employs some 13,000 people in the United States, Canada, and Ireland and grossed \$2.5 billion in sales in 1997, pleaded guilty to 18 felonies and agreed to pay \$37 million in penalties and \$5.5 million for criminal violations of the Clean Air Act.

The corporation was caught only because a former company supervisor filed a lawsuit against it alleging that he had been fired for refusing to tamper with one facility's pollution monitoring equipment. That is a rather haphazard way to regulate, but federal and state environmental officials cannot possibly closely supervise the vast array of firms operating in the United States.

National regulation, where it exists, falls far short. Many governments seem unable or unwilling to ensure that national standards exist and are adequately enforced. No matter how much corporations may complain (sometimes justifiably) about the heavy hand of government regulation, the market side has the upper hand.

To fill the governance gap, an extraordinary variety of nongovernmental groups has sprung up. Activist groups are proving adept at shaming or coercing corporations into paying attention to what activists say are the broader social responsibilities of the private sector. And some in the corporate world seem to be listening.

Corporate Codes: Cover-up, Try-out, or Buy-in?

During the late 1970s corporations began to face nongovernmental pressures to change the way they saw their role in the world. Principles and codes of conduct began appearing, mostly among U.S. companies responding to waves of bad publicity from revelations that some had been paying bribes overseas—a practice banned by the 1977 U.S. Foreign Corrupt Practices Act.

As corporate cross-border activity blossomed, new campaigns demanded change in corporate practices on everything from worker rights to environmental sustainability. By the 1990s, a new "corporate social responsibility" movement was in full swing. Corporations began learning that failing to comply with consumer and investor preferences about their behavior can be costly.

Today many companies are creating "codes of conduct" that go beyond what local law requires. The codes are meant to protect company reputations and reassure consumers that their production processes are environmentally benign and that working conditions are decent.

Sometimes governments encourage the code-of-conduct trend. In the United States, the Clinton White House set up an Apparel Industry Partnership that put forward a code of conduct setting standards for working conditions, applicable not only to participating companies but also to their foreign contractors. Business associations have also gotten in on the act. In 1990 the International Chamber of Commerce set forth a Business Charter for Sustainable Development that has since been signed by more than 2,500 companies worldwide.

But the big push for such codes has come from civil society groups, whose intense public criticism of corporate behavior can drive away customers and investors if left unanswered. Their spotlight has shone even on firms that consider themselves socially progressive. Starbucks Coffee, faced with intense picketing by activists denouncing conditions at the Guatemalan coffee plantations where it purchases beans, eventually issued a code of conduct and action plans for all its suppliers.

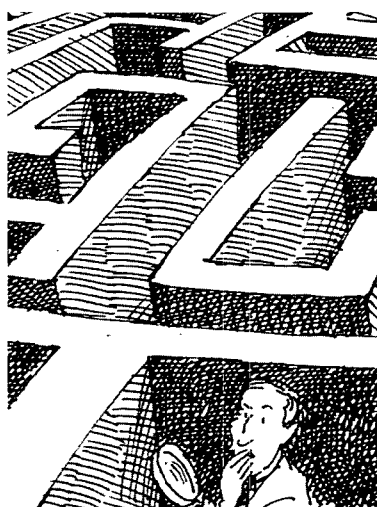
By now, almost every self-respecting large corporation has a

code of conduct. But the codes are highly controversial. Proponents generally see them as a valuable way to get corporations to buy into new norms of behavior without the need for government intervention, making them attractive to corporate leaders who want to fend off government regulation. More ambitious proponents see them as a means of gradually achieving consensus around standards of behavior that can be tried out voluntarily, then eventually adopted and enforced by governments. Detractors portray them as mere fig leaves.

Corporate codes are of two sorts. The first is "aspirational"—a general statement of what corporations aim to do. The Caux Principles, put forward by the Caux Roundtable, a group of senior executives from leading firms based in Europe, Japan, and the United States, are a good example. They consist of general principles, broad to the point of mushiness (corporations should operate in a spirit of honesty and fairness, should contribute to the economic and social development of the communities where they operate and the world community at large), and slightly more specific stakeholder principles—essentially

promises to obey the law and not to cheat. Human rights get a brief mention. But the Caux Principles' formulators point out one big selling point: because the document was devised by business leaders, its ethical norms are more likely than those from other sources to be broadly accepted by the business community. Many firms use the Caux Principles as the basis for their own codes of conduct.

These aspirational codes require no confirmation of whether firms are meeting their commitments. Because the



Corporate leaders are struggling with fundamental questions about how far their social responsibilities extend.

codes are arising piecemeal—by the thousands, all with different specifications—comparing what various firms are promising to do is difficult. And many firms do no monitoring at all.

The second type of code is more demanding. It requires specific commitments on labor or environmental standards, along with independent confirmation of whether commitments are being met. Once a code is established, an independent external auditor comes in, assesses whether a company is in full compliance, and if so certifies it. The firm can then advertise its compliance and display the stamp of approval on its products. The nonprofit Council on Economic Priorities, in collaboration with human rights organizations, businesses, and auditing companies, devised a code of conduct called Social Accountability 8000, intended to become the global standard on workers' rights. Companies that adopt the code permit outside auditors to inspect every facility and assess practices on child labor, health and safety, freedom of association, the right to collective bargaining, discrimination, disciplinary practices, working hours, and—a matter excluded from most corporate codes—whether compensation provides workers a living wage.

Compliance with such externally monitored codes of conduct is completely voluntary. No government enforces them; no international organization has made the standards law. Instead, the assumption is that corporations will want to be so certified because they will find it good for business—because consumers will prefer to buy certified products.

How successful such codes will be remains unclear. A few big companies, including Toys R Us and Avon, have announced they will buy only from SA-8000-certified suppliers, and Avon is the first to be so certified. But some industry groups object strongly, arguing that the ever-mounting costs of certification with the growing array of standards are too great and that industry should set and monitor its own standards.

They have a point. Certification is expensive. Corporations are being flooded with demands to meet standard after standard. Some demands come from groups whose claim to represent a broad public interest seems dubious. It is not at all clear who should decide exactly what standards the codes should uphold.

Another question is: "*Quis custodiet custodes?*"—who will watch the watchers? The complexities show up in the current competition over who should monitor the treatment of overseas labor by U.S. garment manufacturers, who are often accused of subjecting their workers to sweatshop conditions. On one side is the Fair Labor Association (FLA), the outcome of a Clinton administration presidential task force that included both human rights groups and major corporations. On the other is the Worker Rights Consortium (WRC), a university coalition formed by the United Students Against Sweatshops (USAS). The two groups hotly contest each other's motives, methods, and primary goals. FLA member companies agree to have conditions in their overseas contractors' factories monitored by independent agencies, but the company hires the monitor and the reports are not made public. The USAS says this is not good enough, and it set up the WRC to inspect fac-

tories that produce goods bearing the trademarks of and licensed by American colleges and universities.

Such problems are not surprising. The certification approach is essentially an effort to replace a government function—inspection—that even most governments have found difficult to do. There is no particular reason to think private inspectors will systematically do better than public ones or that private resources can readily be found to pay for necessary inspections if public resources are unavailable. By default, many of the private inspections are being carried out by big accounting firms, whose expertise lies in a different kind of inspection.

PricewaterhouseCoopers, the leader in "social accounting," allowed Dara O'Rourke, of the Massachusetts Institute of Technology, to accompany its auditors on factory inspections of labor practices in China and Korea. O'Rourke's report is disturbing. In one inspection, the PwC auditor found some questions she was supposed to ask workers "embarrassing" and skipped them; she answered other questions herself without bothering to ask the workers. In another, the factory president selected the workers to be interviewed, and the auditors skipped all questions about freedom of association, collective bargaining, child labor, and forced labor, claiming that because the factory had no union the questions were not relevant. In both cases, the auditors, financial specialists who had gotten a crash course in social and environmental monitoring, missed major health and safety violations.

The Global Compact

A third model can be found at the United Nations. In 1999, UN Secretary-General Kofi Annan promulgated a "Global Compact" which he asked corporations to sign to indicate voluntary adherence to nine widely accepted UN principles on human rights, labor standards, and the environment. Signatories are supposed to report annually on progress in implementing these principles. The Compact thus does not require outside certification but does insist on at least some degree of public accounting.

The Global Compact, like most compromises, provokes criticisms from both sides. Activist groups object to the unverified self-reporting, claiming that notorious corporate bad guys will be allowed to wrap themselves in the UN logo without making any real change. The head of the International Chamber of Commerce protests that "business should not be called upon to meet demands and expectations that are properly the preserve of governments."

Despite such skepticism, voluntary corporate codes may improve corporate behavior even without the coercion that backs up governmental regulation. Companies do care about their reputations. Reputations are increasingly going global, leaving corporations increasingly vulnerable to new pressures.

Even self-reporting systems such as the Global Compact could turn out to be more effective than expected if corporations take seriously (or are pressured into taking seriously) the reports they are supposed to file each year. Self-reporting, while not ideal, has two potentially beneficial effects. First, it

forces the corporation to take a look at its own practices, if only to justify them. Although many corporations will seize the opportunity to exercise the art of spin, some will discover things about themselves that they may want to change. Second, activist groups won't accept those reports at face value. Several groups have already promised to scrutinize them. By signing the Compact, the corporations have agreed to be held to standards of behavior going beyond what governmental regulations require. The activist groups intend to provide the fire to hold to the corporations' collective feet.

Who Knows?

Whether the groups can do so depends on whether they can amass meaningful information about the degree of corporate compliance. The big missing piece in the corporate code puzzle has been how to make the necessary information public in some systematic fashion that makes it possible to compare organizations and to evaluate claims of good (or bad) behavior.

Into the morass has stepped the Global Reporting Initiative, a polyglot array of corporations, accounting firms, and environmental, human rights, and labor organizations, which has developed a framework for voluntary reporting on corporate economic, environmental, and social performance. Its Sustainability Reporting Guidelines, tested in draft form on 21 companies in the late 1990s, were revised in June 2000 and again in 2002. Already, companies are using the GRI framework to report on their compliance with the UN Global Compact.

Who Cares?

All disclosure-based "regulation" depends on the assumption that someone somewhere cares about the information that gets released. The usual argument, especially by certifiers, is that consumers care, particularly consumers in rich countries with the buying power that impresses corporations. Unfortunately, the share of consumers who demonstrate a preference for "certified" goods is substantially lower than the share who make that claim in marketing surveys. Consumer pressure has had far more success improving product safety than working conditions. It took unions—workers looking out for their own interests—to do that.

But corporations have other obligations besides those to consumers. They must also satisfy investors. And rapidly growing numbers of investors are adding social responsibility to their criteria for selecting companies in which to invest. Shareholder activism first became prominent in the late 1970s as part of an anti-apartheid campaign against South Africa and has flourished, most strikingly in the United States. In

1984, according to the Social Investment Forum, roughly \$40 billion in U.S. assets under professional management had undergone some sort of social or environmental screening. By 1995, the total was \$639 billion. Two years later, it had cracked the \$1 trillion mark, and by 2001, it had reached \$2.3 trillion.

What constitutes socially responsible behavior varies according to who is doing the screening. The single most widely used criterion is simple: no tobacco. Screens can include everything from environmental sustainability to treatment of workers to animal rights. Religious mutual funds and indexes use the beliefs of specific faiths as criteria.

Focusing on investors addresses one key legitimacy question about screening. Even in the most conservative perspective on the social role of the corporation, those who own it are entitled to a significant say in what goals it should be trying to achieve. And with evidence mounting that screened investments match or outperform the market, the \$6 trillion locked

up in U.S. pension funds may offer another avenue for growth. People who control workers' pensions just might find themselves under pressure to take seriously workers' rights.

Regulation by Revelation

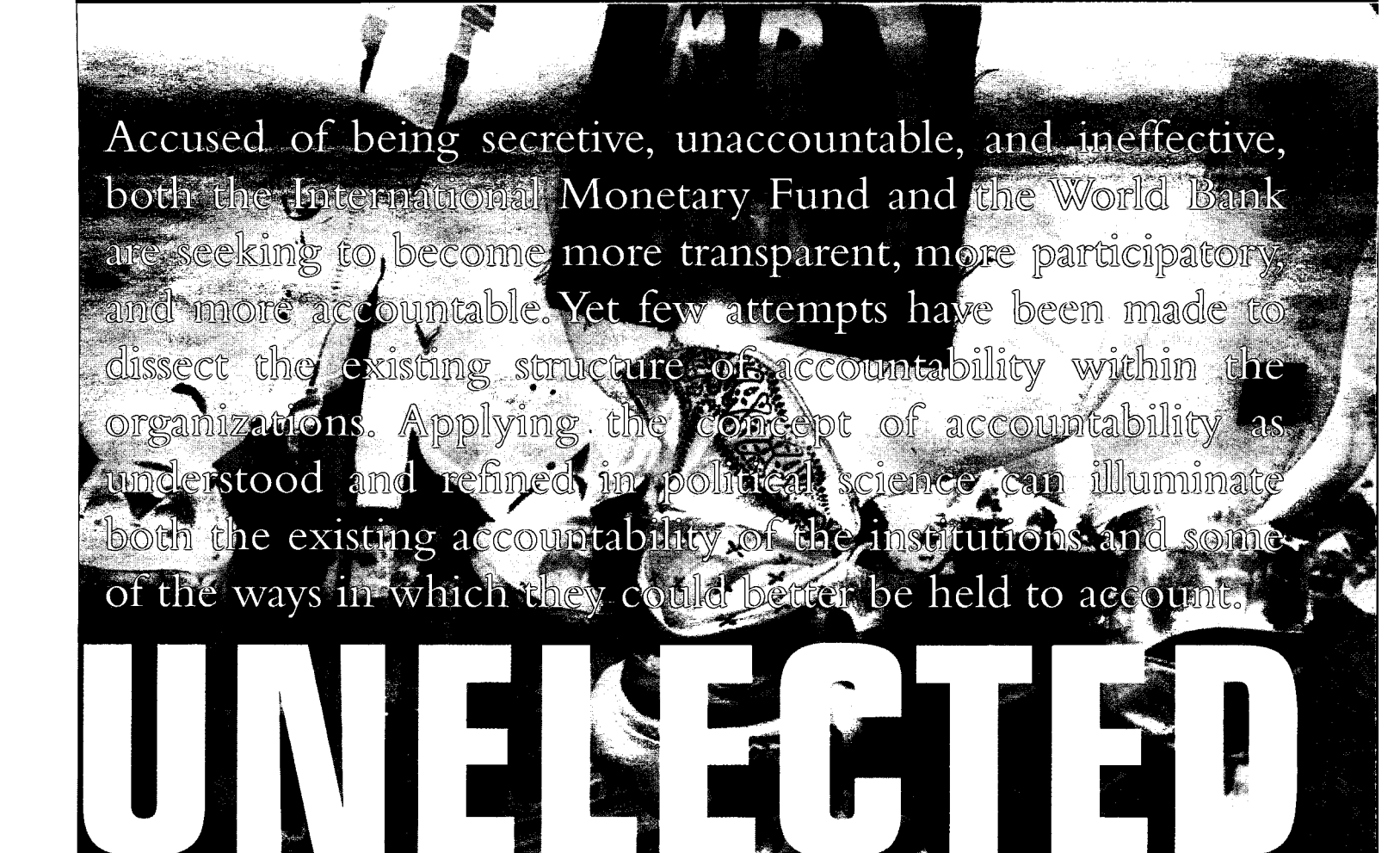
The effort to devise meaningful rules for global corporations matters greatly. Future global prosperity depends in part on whether corporate practices encourage a widespread sharing of the benefits of economic integration, and future environmental stability depends on whether corporate activities are carried out in an environmentally sustainable fashion. The private sector could decide of its own volition to behave with the necessary degree of social responsibility, either out of altruism or from an enlightened view of long-term self-interest. Some will, but most probably will not. Nor will governments be able to regulate them into compliance with high standards, given the lack of capacity of many governments and the growing ability of corporations to pick up and leave any too-effective jurisdiction. Thus the need for credible regulation by revelation, using transparency to determine whether corporations

are adhering to codes of socially responsible conduct.

Those who distrust corporations on principle will not be satisfied with such "soft law," and no one can yet be assured the approach will work on a large scale. This soft approach is an evolving process. Increasingly, corporations are being held to new standards of social responsibility that go far beyond legal requirements to enrich shareholders and obey the rules governments make. The dispute over exactly what those standards should be—and who should decide—has just begun. ■



**What
constitutes
socially
responsible
behavior varies
according to
who is doing
the screening.**



Accused of being secretive, unaccountable, and ineffective, both the International Monetary Fund and the World Bank are seeking to become more transparent, more participatory, and more accountable. Yet few attempts have been made to dissect the existing structure of accountability within the organizations. Applying the concept of accountability as understood and refined in political science can illuminate both the existing accountability of the institutions and some of the ways in which they could better be held to account.

UNELECTED

Government

By Ngaire Woods

MAKING THE IMF AND THE WORLD BANK MORE ACCOUNTABLE



Accountability to Governments

Like many international organizations, the IMF and the World Bank face complex problems of accountability that originate in a simple question: to whom should they be accountable and how? Democratic political systems ensure accountability not just by elections but by mechanisms such as transparent decisionmaking, judicial review, and the use of ombudsmen. The aim is to ensure that political actions are predictable, nonarbitrary, and procedurally fair, that decisionmakers are answerable, and that rules and parameters on the exercise of power are enforced.

Unlike a democratically elected government, international institutions cannot claim that voters elect them and can vote them out of office. Nor have they been subjected to the normal restraints politicians face from the checks and balances of government, including the role played by judges, ombudsmen, and the like. Rather, international organizations

governance structures of both organizations reflect that early vision. Today, however, both lend only to developing and transition countries, and both condition their lending heavily on broad changes in borrowers' economic policies. Indeed, "conditionality" has widened dramatically over the past couple of decades, increasing the intrusiveness of the institutions' work and changing the nature of their relationship with stakeholders. Yet their structure of accountability has remained in many ways unchanged.

In both the Fund and the Bank, the basic structure of accountability works through representatives of governments. At the top of the system, Boards of Governors meet just once a year and are supposed to maintain overall oversight and control of the institutions. The day-to-day work is overseen by executive-directors, representatives of member states who sit on the Executive Boards and perform a dual role. Individually

dom, Saudi Arabia, Russia, and China—are directly represented by their own executive-director. All other economies are grouped within constituencies represented collectively by just one executive-director. Most national governments thus have only the weakest link to formal deliberations and decisionmaking. In the IMF, for example, 21



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grapple with an unwieldy structure of government representation that makes ensuring their own accountability extremely difficult. Until roughly the 1980s, the mission of the IMF and the World Bank was narrowly technical, and accountability, accordingly, less of an issue. Today, however, both the Fund and the Bank are being pushed by their most powerful members to perform a much wider range of tasks directly affecting a broad range of people. The need for accountability has thus become more critical.

The IMF and the World Bank were established after World War II as mutual assistance organizations through which all member countries could help each other with postwar reconstruction and development as well as with balance-of-payments problems. The voting and

each executive-director represents a country or a group of countries; collectively they manage the organization. They appoint and can dismiss the head of each organization, who in turn controls the management and staff.

The chain of representative accountability is long and imperfect. The links between most member governments and the IMF and the World Bank are extremely weak. Most member governments (with the obvious exception of the United States) are too far removed from the workings of the Executive Board, which in turn exercises too little control over the staff and management. Four elements of this are worth elaborating.

Unequal Representation of Member States

The Executive Boards are the vital link from countries to the IMF and the World Bank. Yet only the largest member countries—the United States, Germany, France, Japan, the United King-

dom, Saudi Arabia, Russia, and China—are directly represented by their own executive-director. All other economies are grouped within constituencies represented collectively by just one executive-director. Most national governments thus have only the weakest link to formal deliberations and decisionmaking. In the IMF, for example, 21 Anglophone African countries, at least 11 of which have an intensive-care relationship with the institution and all of which are deeply affected by its work, are represented by a single executive-director and have a voting share of 3.26 percent. In the World Bank, the same group of countries plus the Seychelles is represented by one executive-director and has a voting share of 4.07 percent. This small formal share of votes reflects a rationale that was appropriate to the organizations' original mandate and membership. Each, at its inception, had far fewer member states; membership has since more than tripled, with decolonization creating a host of new, independent states. Originally, members were mutually assisting, and each had a vote proportional to its stake. Now that both the Fund and the Bank make highly conditional development loans only to developing and transition economies, the traditional voting structure looks anachronistic and inadequate as a formal mechanism of accountability.

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Inadequate Oversight of Staff and Management

Although the Executive Boards appoint and oversee the senior management and work of both institutions, several practical impediments complicate this role. Often both Boards are perceived as simply nodding through decisions already made by the staff and management in consultation with the most powerful member countries. Several organizational features play into this. The Board is not independent of the staff and management. Executive-directors are paid by and housed within each institution and have a dual role as officials of the organization as well as representatives of countries; many flit from Board to staff and back again. Many executive-directors are ill placed to follow closely and to prepare positions on all issues in front of them. Unlike their counterparts in the G-7 (the finance ministers and central bankers of the seven major industrialized countries), few have the advantage of

and policy attention to the lack of transparency and accountability, both institutions established committees to improve the appointment process, but the result was pretty much an endorsement of the status quo—a failure on the part of U.S. and European members to put into practice their rhetoric.

Broad Conditionality, Narrow Accountability

All these accountability problems have been magnified by the increase in and transformation of the activities of the IMF and World Bank. Figures compiled in both institutions show a dramatic increase in the number and scope of conditions placed on loans in the past several decades. During the 1980s, loans to a sample of 25 countries were conditional on between 6 and 10 “performance criteria.” During the 1990s the number of performance criteria had jumped to about 25. Borrowing countries are now being required to mobi-

more appropriately be held to account by the population of the country.

Steps Toward Greater Accountability

Aware of the criticisms they face, and frustrated by their limited effectiveness in implementing wider policy reform, both the IMF and the World Bank have begun more explicitly to recognize a wider range of stakeholders in their work. Both are making themselves more accountable to such stakeholders through more transparency, new mechanisms of horizontal accountability, and closer collaboration with nongovernmental organizations. The implications for accountability are several.

Although transparency has improved, several crucial gaps remain. The Fund has yet to publish its internal rules, guidelines, and operating procedures; the Bank, the full output of its Operations Evaluation Department (OED). The omissions are important. The Fund

governments and the World Bank are extremely weak.

resources and staff working on Fund and Bank issues in their constituency countries. Furthermore, when proposals come before the Board, executive-directors are not privy to the disagreements and alternatives that have been debated among staff and senior management. The latter present just one proposal to the Board, leaving executive-directors either to accept or to reject. Fine-tuning is seldom entertained.

Flawed Appointment Process

Neither the Bank nor the Fund has an open and transparent process by which to appoint its head—to whom all staff are accountable. Rather, according to a 50-year-old political compromise, the head of the World Bank is an American and the head of the IMF is a non-American, in practice always a Western European. This process came under scrutiny several years ago, when Germany's first candidate to head the IMF failed to win support from other major shareholders. Sensitive to adverse press

lize, redefine, strengthen, or upgrade government processes in an ever wider range of areas.

The conditionality in which both the Fund and the Bank engage affects budgets and policies in areas such as health care and education. Although both organizations now consult with civil society and a broader range of stakeholders, their formal accountability remains unchanged. Their official interlocutors, as set out in their Articles of Agreement, are the Treasury, Finance Ministry, Central Bank, or equivalent agency of a borrowing country. Such transactions erode democratic accountability in several ways. First, domestic policy discussions on health or education are weighted in favor of the Treasury or Central Bank view because these agencies are the conduits of Bank and Fund financing. Second, agreements make the Finance Ministry or Central Bank formally accountable to the Fund and Bank for policies for which a Minister of Education or Health should

can be accountable to its members only if they (in the broad sense of they) are privy to the guidelines and conventions governing the internal operations of the staff—especially given the weaknesses of the Board in holding staff and management to account. Making public the agencies' self-evaluations would invite outside scrutiny that could not only strengthen external accountability but also ensure that the IMF and the Bank take seriously their own reviews. But transparency, though necessary, is not sufficient.

Monitoring and enforcement are also vital. National political systems rely on a combination of constitutionalism and democracy. In the U.S. system, for example, democracy is served by Congress; constitutionalism, by the Supreme Court. Electoral accountability is given life through “horizontal” accountability—agencies and processes that monitor and enforce the mandate, obligations, rules, and promises of institutions.

The IMF and the World Bank have

both recently created several agencies and processes to enhance horizontal accountability. The IMF's new office for independent evaluation published its first study in 2002. More boldly, in 1993 the World Bank Executive Board created an inspection panel to consider complaints from groups claiming to have been adversely affected by the Bank's failure to follow its own policies or procedures. In 1999 the Bank created a compliance officer-ombudsman's office to deal with similar complaints about its International Finance Corporation and Multilateral Investment Guarantee Agency.

Both the Fund and the Bank are working in a world in which more people aspire to hold them to account. A wide range of nongovernmental organizations and other groups will continue to demand that both be more open and transparent, not just about what they do but about how they do it. The IMF has yet to rise to that challenge—not just by publishing its internal rules but by subjecting itself to independent review to ensure that its rules and guidelines are being respected. For example, an independent agency could monitor closely how the IMF applies its Guidelines on Conditionality (revised in 2002), thus permitting the Fund's interlocutors to speak frankly about their work with Fund staff to produce programs and to record and measure their experiences against the standards the Fund has set itself.

Finally, both institutions have responded to demands for greater accountability by diversifying their contacts, in particular with nongovernmental organizations. They no longer refer to their interlocutors in member countries exclusively as "national authorities." Rather, the World Bank writes of "development partners"; the IMF, of "authorities and civil society" and of the need for its programs to enjoy "ownership by the societies affected." At

regional, country, and local levels, World Bank regional directors and IMF resident representatives are being told to seek out and maintain contacts. At the annual and spring meetings, both institutions have been actively involved in more dialogue and meetings with a select group of transnational NGOs. Both have also begun to demand local participation by nonstate actors, as in the poverty-reduction strategy papers being required of countries seeking enhanced debt relief.

This is not to say that NGOs have taken a place as major stakeholders: they have acquired neither control nor a formal participatory role in decision-making except at the behest of their own governments. Transnational NGOs have fostered a global debate about what international organizations are doing and have been crucial in monitoring and demanding accountability from global actors. In turn, their own accountability is often questioned, particularly where Northern NGOs have allied with or used political leverage in major shareholding countries such as the United States. Developing countries complain that such NGOs end up with a stronger voice in the Fund and Bank than many smaller developing countries.

Different concerns are raised about local or grassroots NGOs. No one doubts the value of independent groups of citizens committed to monitoring their own governments. The question is whether the Fund and Bank can facilitate such a process. Critics argue that in fostering wider participation, the IMF and the World Bank become gatekeepers of social organizations and power. Because the institutions must choose which NGOs to recognize and consult, they end up making decisions with deep social and political consequences. They create incentives for government officials to moonlight as NGOs, thus avoiding electoral and constitutional account-

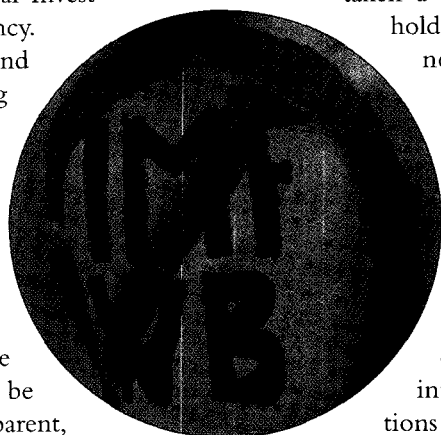
ability. They also create organizations that siphon away resources and talented officials from government departments.

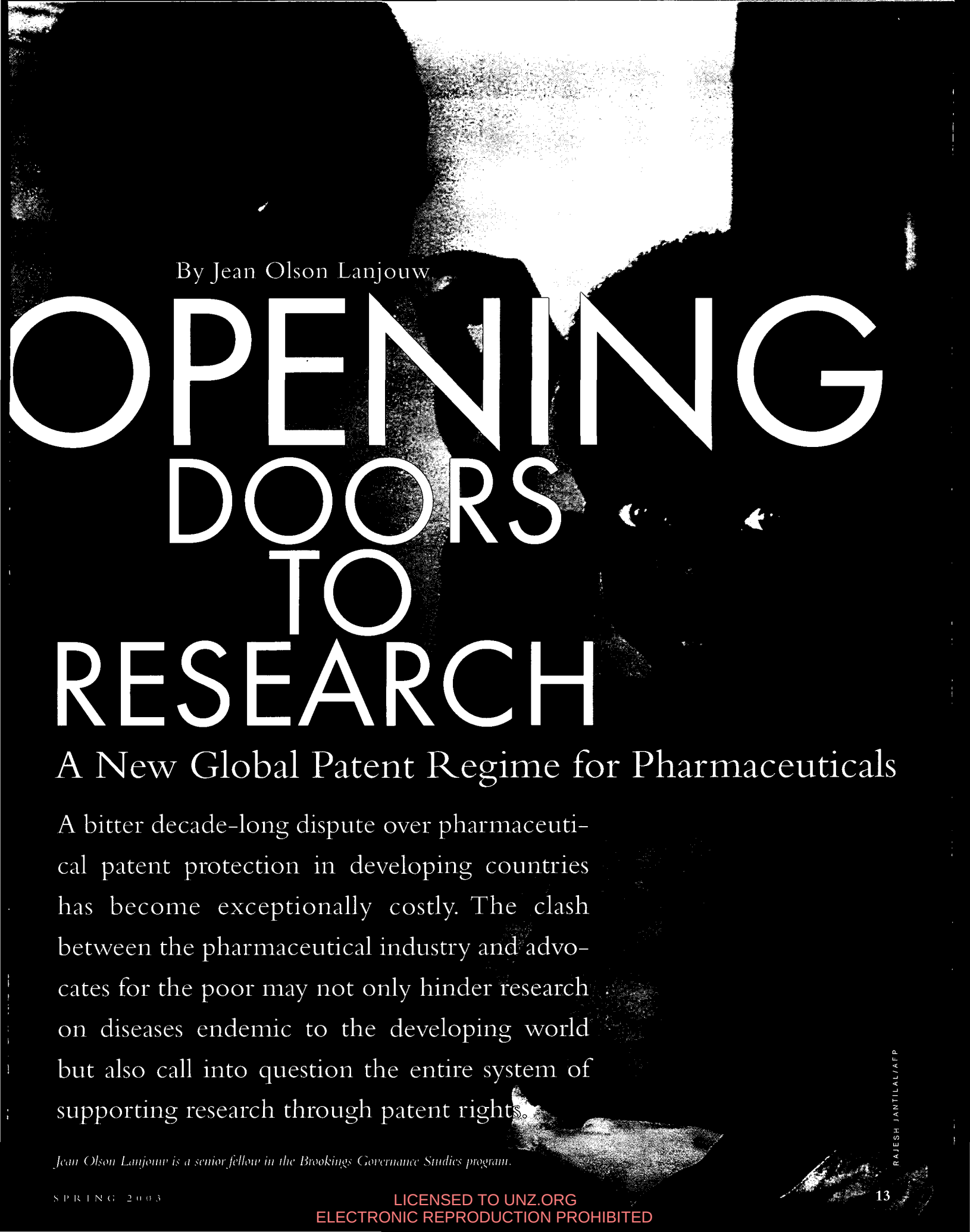
In sum, improving relations with nongovernmental groups will not erase the accountability deficit in the Fund and Bank. It takes the institutions into a minefield of social and political relations through which they must step with maximum knowledge and caution. And it does not obviate the need for the most powerful members of both intergovernmental organizations to modernize the ways in which each is accountable to its developing and transition country members.

Looking Ahead

Improving the accountability of the Fund and Bank became a mantra for economic policymakers in the G-7 in the late 1990s. As a result, both institutions became more transparent and opened dialogues with new groups of stakeholders. These measures may improve governance, but they do not solve the core accountability deficit.

Each institution needs a structure of representation that better reflects the stakes of all member states; a stronger, more independent role for the Executive Board in overseeing the work of the staff and management; a transparent set of operating rules that enables others to monitor how they do their work; and an open and participatory process for appointing the head of each organization. Perhaps most important, the powerful members of each institution must restrain their urge to have the Fund and Bank engage in conditionality across a wide range of issues. As a rule of thumb, the scope of the activities of the Fund and Bank should not exceed the scope of their accountability. If they represent and negotiate with Central Banks and Treasuries, their work should not stray beyond the mandates of such agencies. Rather than impose strong external accountability on weak national systems, they should whenever possible look for and strengthen local kinds of accountability. In the longer term, people need to hold their own governments to account regardless of IMF and World Bank strictures. ■





By Jean Olson Lanjouw

OPENING DOORS TO RESEARCH

A New Global Patent Regime for Pharmaceuticals

A bitter decade-long dispute over pharmaceutical patent protection in developing countries has become exceptionally costly. The clash between the pharmaceutical industry and advocates for the poor may not only hinder research on diseases endemic to the developing world but also call into question the entire system of supporting research through patent rights.

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Setting patent standards was one of the most contentious issues in negotiations leading to establishment of the World Trade Organization in 1995. After heated debate, WTO founders agreed to require all member countries, including those in the developing world, to issue patent rights on pharmaceutical products. The decision sparked angry criticism, which has only intensified with growing awareness of the AIDS crisis and the development of effective, but expensive, drug therapies to combat the disease. Although the pharmaceutical industry insists on the benefits of strong patents on drug innovations, others are adamant that inventors should have only limited rights to control the sale of pharmaceuticals in the developing world, or no rights at all. Pharmaceutical firms' current strategy—to negotiate price and licensing terms product-by-product and country-by-country for the developing world—has left them vulnerable to criticism by advocates for the poor. The negative attention focused on the industry has implications that go far beyond development, and compromise on this highly charged issue is urgently needed.

The Roadblock of Uncertainty

Patents exist to stimulate research. But the current uncertainty about the form of future patent rights in the developing world prevents patents from being of any use as a research incentive there. Why would a pharmaceutical firm invest now in a product for a poor country when it can have no way of knowing what patent protection will be available there in 10 years once product development is finally complete and the product is ready to market? This fallout of the long-running dispute is particularly unfortunate because it hinders research on drugs for diseases, such as malaria, that kill millions of people in the developing world each year. These diseases receive few research dollars, and private incentives to invest have been largely absent. Until a more predictable and reliable global system is set up, patent rights can do nothing to help bridge this gap.

What would a predictable and reliable system look like? For patent rights to be predictable, the rules must be clear. This means avoiding the ambiguities that give rise to disputes over interpretation. For patent rights to be reliable, the global system must be viewed as "fair." Otherwise, inventors will continue to risk attack if they try to exercise their patent rights.

For the global system to be seen as fair, it will surely need to recognize differences in the development level of countries. Too many people remain unconvinced that the poorest countries should be required to set up a U.S.-style patent system. In fact, many of the developed countries themselves did not protect pharmaceutical innovations until they reached a far higher level of income than the poor countries have today. Greece,

Norway, Portugal and Spain, for example, introduced pharmaceutical patents only in 1992, when GDP per capita exceeded \$12,000 (in 2001 dollars).

Disagreement over the appropriate form of global patent rights has gone on for a long time and has become very public. Positions on both sides are entrenched. But finding a resolution remains imperative. How can a patent system recognize differences in countries' well-being and, at the same time, encourage the private sector to become involved in creating new products for the developing world?

One solution would be to establish a system where patent protection in poor countries *differs across diseases* depending on the importance of those countries' markets as a potential source of research incentives. No one, for example, would argue that African nations are an important source of incentives to do cancer research. The search for a cure for cancer is driven by demand from the big Western markets. Demand in Africa, however, might be sufficient to spur more malaria

research. Under the system I describe below, patent protection would be minimal in the poorest countries and would broaden gradually to cover more diseases, starting with those, like malaria, that are particularly prevalent there. Protection would grow as a country became richer and its market significant, but not before. Such an approach automatically tailors the patent system both to development levels *and* to the characteristics of different drug markets.

Pricing and Research Incentives

Supporting pharmaceutical research and development through a patent system entails an unavoidable trade-off between lower prices and new products. A patent right confers a monopoly

that raises the price that consumers (and governments) face in purchasing a pharmaceutical drug—and thus may put the drug out of reach of some disease sufferers. Yet this monopoly right also provides companies with incentives to invest in research for new drugs that may one day save millions of lives. Weaker patent rights allow more competition and lower prices, benefiting patients today. More extensive patent rights raise prices, giving firms greater reason to invest in creating frontier products that may cure future disease sufferers.

Extending patent rights to new countries, however, does not inevitably lead to significant new research investment. When profitable markets exist elsewhere and the countries introducing patent protection are small, new rights will have little effect, for they will add only a small increment to an already large market. But, as suggested, the global drug market consists of two different markets—one for diseases specific to developing countries and another for global diseases. Taking into account these different markets offers a way to use patents

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to support research on diseases specific to developing countries while allowing competition to lower prices on products developed for rich-country markets.

Why Have Patents in Poor Countries At All?

No one disputes the need for more investment to fight diseases that cripple developing countries while sparing rich countries. Diseases like malaria, Chagas' disease, and leishmaniasis afflict millions of people, yet have received almost no research investment from the private sector and little from the public sector. Only 8 of 1,233 drugs licensed from 1975 to 1997 (less than 1 percent) were developed specifically for tropical diseases in humans. For every thousand references to diseases in scientific papers in 1998, just 15 were to developing country-specific diseases. Only one-half of 1 percent of pharmaceutical patents issued in 1998 were related to those diseases. Clearly, past policies that have *not* included patents in the developing world have largely failed to create the incentives for products for the particular health needs of the poor.

Can new patent rights change this situation? No one views the weak incentives for investment as stemming solely from the lack of patent protection in the developing world. Investment is weak because people in the developing world are poor. The World Health Organization estimates that in 17 of

the poorest countries, no more than \$10 per person was spent in 1998 on *all* health care, not just pharmaceuticals. In such small markets, merely introducing patent protection will not suffice to reorient the research priorities of private firms. But global private-sector R&D in pharmaceuticals topped \$30 billion in 2001—and is still growing. If patents can shift even a tiny fraction of that investment in the direction of products to treat diseases endemic to poor countries, those funds would offer a significant complement to ongoing public and philanthropic investment. New patent laws in the developing world on drugs *for diseases specific to those countries*, therefore, may encourage greater research.

But what about patents for drugs aimed at diseases common worldwide? These diseases also claim millions of victims in poor countries. In fact, people in developing countries lose four times more disease-adjusted life years from just two global diseases, cancer and heart disease, than from malaria. The high incidence of these diseases in developing countries is reflected in the large share of their drug spending targeted on global diseases. In 2000 spending on cardiovascular drugs alone was 8 percent of total drug spending in Mexico, 13 percent in Mexico, Argentina, and Brazil together. Because poor countries have limited resources, however, their spending on drugs is a tiny part of pharmaceutical spending worldwide. For

AP/WIDE WORLD PHOTO

example, six poor countries with 46 percent of the world's population—China, India, Indonesia, Pakistan, the Philippines, and Egypt—are estimated to account for less than 2 percent of global spending on drugs for cardiovascular disease.

The disparity between rich and poor countries in spending on drugs for global diseases is important. It means that the profits pharmaceutical companies derive from having a patent-based monopoly over sales in poor countries contribute relatively little toward those companies' worldwide profits—and therefore toward their incentive to invest in research. High demand in rich countries drives R&D investment for pharmaceuticals treating global disease. At the same time, patents that increase drug prices even a little can cut millions of people in poor countries off from these drugs.

In short, extending patent protection in poor countries to increase research on diseases such as malaria makes sense; extending it to encourage research on global diseases is less obvious.

Proposal for a Multi-Market System

I have proposed a system of pharmaceutical patent protection that would take into account this reality of the global pharmaceutical market. Drugs for diseases specific to developing countries would enjoy patent protection worldwide, thus giving the greatest support possible to R&D where incentives are weak. For drugs for global diseases, patent owners would be required to choose their market. Would they rather have patent protection in the rich countries or in the poor countries? Given this choice, they would typically choose the rich countries—the source of their profits—and thereby allow competition to dampen prices in the poor countries.

The system would not be difficult to implement. It would be consistent with WTO membership and would require no

change in international treaties. It would require only minor changes to patent law in the United States and other developed countries with research-based pharmaceutical firms. It would impose no regulatory burden on developing countries.

It would work as follows (from the perspective of implementation by the United States). By law, someone inventing in the United States must request a “foreign filing license” from the U.S. patent office before filing patent applications abroad. The mechanism simply requires that a patentee petitioning for this license sign a declaration along these lines: *I, the undersigned, request a license to make foreign patent filings covering the invention described in U.S. patent application no. X, with the understanding that this permission will not be used to restrict the sale or manufacture of drugs for [a list of global diseases] in [a list of poor countries] by suing for patent infringement in [a list of poor countries].*

How would the mechanism work? Suppose a firm has begun selling its patented drug in a poor country. It has three options if a competitor begins to sell the same drug. The firm can compete, exit the market, or sue for infringement. If it competes or exits, it does not make use of its patent rights in the poor country. If it chooses to sue, it protects its poor-country market on the basis of its patent there. If the firm's product is for a *listed global disease*, the firm will, by filing a suit, have falsified its declaration to the U.S. patent office—causing its U.S. patent to be unenforceable and allowing generics firms to enter the U.S. market. If the product is *not* for listed global diseases, the suit will proceed and the firm will have patent protection in all countries.

Because filing a suit would put a firm's U.S. market in jeopardy, firms would rarely file suits. Monitoring would be done by generics firms eager to enter the U.S. market. Almost no government spending would be needed for administration or enforcement. Should a suit arise, information that was already

CONTROLLING ILLEGAL TRADE

Pharmaceutical firms have a legitimate concern that drugs sold at low cost in developing-country markets will find their way back into rich-country markets. How are firms to prevent small, lightweight products sold cheaply in a country where consumers are poor from flowing back into markets where people will readily pay more for them? How are customers to know whether a web-based pharmacy is a legitimate

domestic firm and not a counterfeit operation based overseas?

Any global patent system or other policy that offers drugs at lower prices to poor countries will incur the risk of illegal arbitrage. It can be difficult for firms and countries working individually to block illegal imports when a product is light and easy to transport, as the trade in illegal narcotics makes clear. Successfully controlling international drug flows will require the cooperation of

governments in countries that are the source of low-cost drugs. The policy I have proposed could help with this concern: settling the dispute over patent protection could improve conditions for such cooperation. Indeed, developing countries that are beneficiaries of the policy could take specific steps to prevent illegal exports. For example, health authorities in those countries could require that manufacturers use markers to identify drugs sold in poorer markets. Firms'

experiences in separating different market segments in the developed world could be useful in this regard.

The issue of illegal trade should not be overemphasized—for two reasons. First, huge national price differentials have existed for decades without causing massive movements of pharmaceuticals from poor to rich markets. Second, strong safety concerns by consumers and tight regulation of pharmaceutical supplies in the developed world limit the potential gray market.

available could be used to determine whether a patentee had falsified its declaration. For example, standard U.S. Food and Drug Administration procedures could be used to determine whether a generic product sold in the poor-country market was for a listed global disease. The generics firm seeking to enter the U.S. market would apply to the FDA for an abbreviated new drug approval of its product, claiming its equivalence to one already marketed in the United States for a listed global disease. The procedure would be precisely the same as that already followed for any generic on the expiration of a patented product. The use of the generic product would be established by the FDA with the issuance of a report confirming bioequivalence.

Identifying Developing Countries and Global Diseases

A transparent and objective procedure would be established to allow the U.S. Patent and Trademark Office to determine the lists of countries and diseases to include in the declaration to obtain a foreign filing license. The country and disease lists would be updated periodically and would change as markets evolved and countries developed.

One possible approach would be a two-step procedure for listing poor countries and corresponding global diseases. It might in fact be practical to specify several sets of countries, beginning with a small set of extremely poor countries and moving toward larger and more inclusive sets. Just as an example, the first set of countries (set A) would include the roughly 40 countries, primarily in Africa but also India, with GDP per capita less than \$500 (constant U.S. dollars). The next larger set (B) would include countries (including all in set A) with GDP per capita less than \$2,000. That set would number roughly 75 countries and would include such countries as Indonesia and China. The third set (C) would include countries (including all in B) with per capita less than \$4,000. That set would number roughly 95 countries and would include such countries as Brazil and South Africa.

Once the country lists had been established, the patent office would draw up a list of diseases for each. To do that, it would identify diseases for which the share of total potential sales coming from each group's markets represents less than some threshold share. Pharmaceutical sales data are already collected regularly and serve as a reasonable indicator of the share of potential profits. So, for example, if sales of drugs to treat a disease in a country group are less than 2 percent of total global sales, the disease would fall under the policy. Disease list A, then, would include all diseases for which drug sales for country set A are less than 2 percent of world sales, and similarly for disease lists B and C.

For countries in set A, spending on drugs would be so low that all diseases would probably qualify; effectively, no protection would be afforded pharmaceuticals. The number of countries in set B gets larger and the countries are also somewhat richer. Their spending on drugs would be greater, so sales on drugs for some diseases would exceed the threshold of 2 percent of global sales; those diseases would no longer qualify and patent protection would become available on them. For countries in set C, just a few diseases would qualify and patent protection would widen further. The above procedure is illustrative only—other GDP cutoffs and more country groups could be chosen, and a market share other than 2 percent might be appropriate.

With this system, the effective patent rights available to a firm with respect to a particular innovation are determined by the content of the license when it is signed. These rights remain the same throughout the life of the patent and the firm can make its marketing decisions accordingly. At the same time, the content of the declaration evolves. A country starting out in group B, for instance, would move to group C as it grew richer and eventually would not be included in the license declaration. The regime would automatically evolve in line with the development level of countries and the importance of different product markets.

The system I am proposing would require no change in international treaties. It would require only minor changes to patent law in the United States and other developed countries. It would impose no regulatory burden on developing countries.

Moving Beyond the Roadblocks

Today positions on pharmaceutical patents are hardened and stakes are high. Firms are reluctant to depart from a strategy of crisis management to entertain systemwide reforms. Advocates for the poor see people dying and have little appetite for reforms that take effect over time and without fanfare.

Everyone is hesitant when confronting new ideas.

The proposed new system provides a middle way. It would extend patents to pharmaceutical firms for products targeted at diseases that afflict poor developing countries. It provides a way to introduce patents gradually in developing countries for drugs to treat global diseases. With a global patent system designed to recognize the dual nature of the world's pharmaceutical markets, we can give a big welfare boost to poor countries while supporting the full implementation of patent systems in the developing world. ■

For Further Reading

For more information about the decade-long dispute about pharmaceutical patent protection in developing countries, including answers to frequently asked questions, see <http://www.cgdev.org/fellows/lanjouw.html>.

Like a microcosm, the contentious 2002 World Summit on Sustainable Development in Johannesburg demonstrated both the broader problems and the promises of global governance. The formal intergovernmental diplomacy of the huge summit produced few tangible results and many disappointments. The political declaration of the 104 heads of state in attendance essentially reconfirmed principles governments had already agreed on a decade

international organizations, and governments are joining forces in an innovative form of governance: global public policy networks.

New Global Challenges for Governance

Since the early 1990s, the driving forces of globalization—technological change and economic and political liberalization—have fundamentally transformed conditions for effective and legitimate governance.

This new global environment presents four challenges for governance. The first is geographic: decisionmakers

groups who strive for greater participation in and accountability of transnational policymaking.

In this new environment, states and international organizations are no longer the only players in the international realm. Nongovernmental organizations and businesses, themselves responding to the pressures of globalization, have reorganized their operations on a transnational scale and are playing a progressively more important role in international relations. More than 40,000 nongovernmental organizations now operate across borders; roughly 60,000 companies have established

Global Public

ago at the Earth Summit in Rio. Indeed, it took considerable effort to convince a few governments not to reverse some of the accomplishments of the Earth Summit. Yet the Johannesburg negotiations also reflected an ongoing transition to a broader notion of networked governance involving not only governments and international organizations but also businesses and nongovernmental organizations.

The transition—what Jonathan Lash, president of World Resources Institute, has described as a “shift from the stiff formal waltz of traditional diplomacy to the jazzier dance” of issue-based networks and partnerships—is part of a larger phenomenon that has emerged over the past decade. To respond to a wide range of contemporary challenges—from protecting the environment, to fighting diseases such as malaria and AIDS, to implementing labor standards and combating corruption—participants from civil society, business,

in states confront an increasing range of issues that can be addressed only by coordinated cross-border action. The second is temporal and arises directly from rapid technological change. The near-complete integration and 24-hour operation of global financial markets, trade, the media, and many aspects of business severely constrain the time available to traditional public policymakers for weighing options and preparing informed decisions. The third challenge is the steadily growing complexity of public policy issues. Decisionmakers in states and international organizations are having to tackle more and more issues that cut across areas of bureaucratic or disciplinary expertise and whose complexity has yet to be fully understood. The final challenge involves legitimacy and accountability. The traditional closed-shop “club model” of intergovernmental diplomacy cannot fulfill the aspirations of citizens and transnationally organized advocacy

transnational ties. States, international organizations, companies, and NGOs now find themselves on the same playing field—and are gradually recognizing their interdependence in shaping the environment in which they operate. The new cross-sectoral public policy networks are responding to that interdependence to confront issues that no single sector, public or private, could successfully tackle alone.

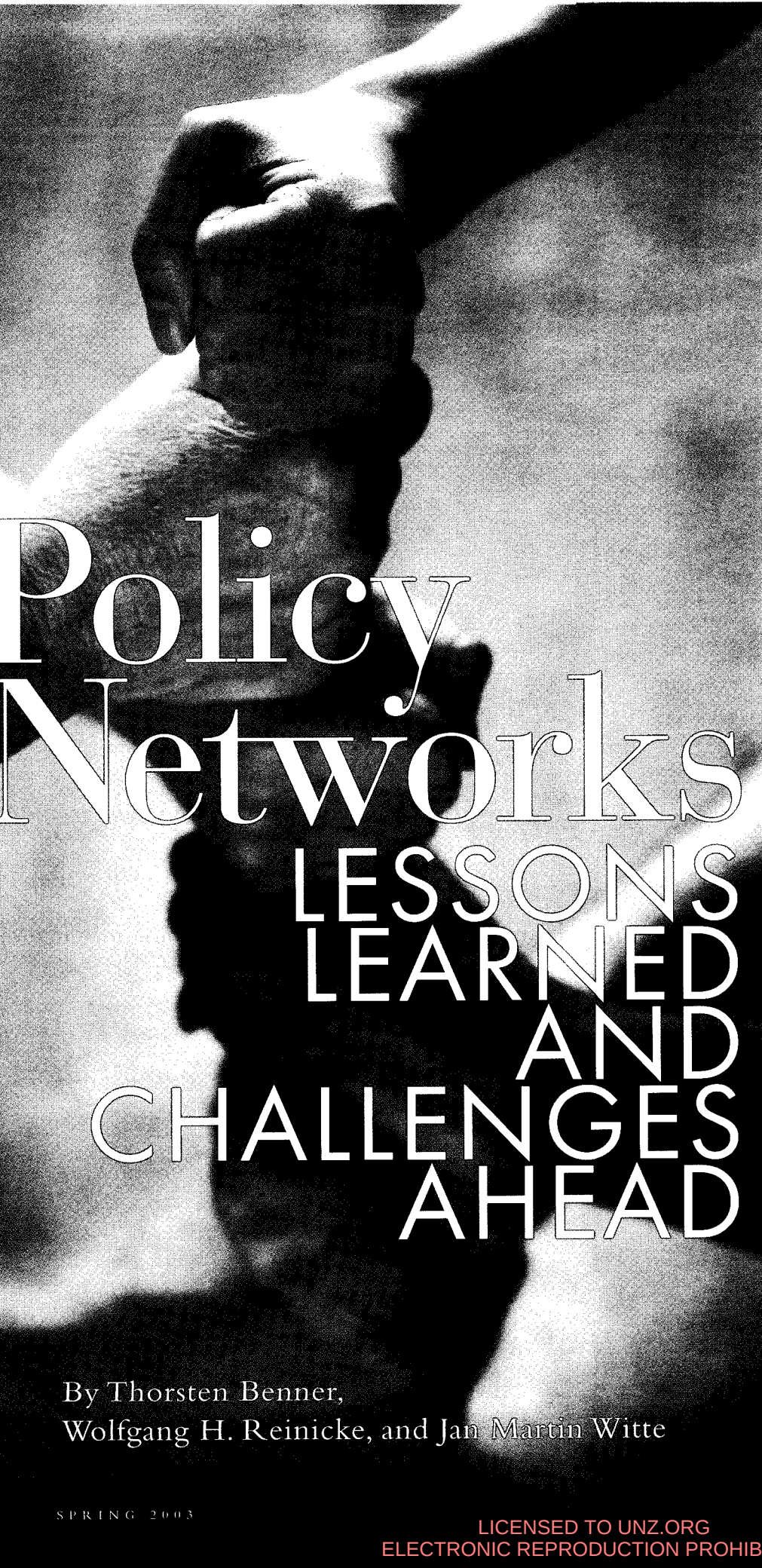
Building Bridges

Global public policy networks build bridges across different sectors and levels, bringing together actors from governments, international organizations, civil society, and business.

Unlike traditional hierarchical organizations, these networks are evolutionary in character and flexible in structure. They bring together disparate groups with oftentimes considerably varying perspectives, combining knowledge from different sources in new ways to result in new knowledge.

As they have developed so far, the networks fulfill three primary functions. Some are negotiation platforms that facilitate the setting of global standards and regulations. Others focus on coordi-

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Policy Networks

LESSONS LEARNED AND CHALLENGES AHEAD

By Thorsten Benner,
Wolfgang H. Reinicke, and Jan Martin Witte

nating resources and correcting market failures. Still others focus on implementing existing international treaties.

Negotiation Networks

Global negotiation networks have developed in complex issue areas such as social and environmental reporting and global water management. The World Commission on Dams, for example, developed in response to mounting conflicts among development planners, contracting firms, and environmental groups about dam construction in the late 1980s. The conflict essentially led to gridlock. Governments and international development organizations such as the World Bank were unable to push forward with new dam projects to alleviate water management problems; companies faced an uncertain business environment; and NGOs invested huge resources to keep large dams from being built.

In 1997 the International Conservation Union and the World Bank convened representatives of governments, the private sector, and NGOs to restart the dialogue, leading to the creation of the World Commission on Dams in May 1998. The WCD was charged with developing a catalogue of standards for large-dam construction based on a comprehensive analysis of large dams' economic, social, political, and cultural ramifications. The commission's 12 members represented the broad spectrum of stakeholder interests, from multinational construction companies to fierce opponents from the NGO world.

The work of the commission was critically reviewed and supported by a 50-member stakeholder forum, again with representatives from all parties. The commission analyzed the construction of 125 dams and their social and ecological repercussions, undertook numerous local and regional consultations as well as in-depth case studies, and then developed a catalogue of standards and criteria for future dam construction. The catalogue was published in November 2000, and the commission was dissolved the following April. A new institutional structure—the Dams and Development

PIERRE TREMBLAY/MASTERFILE

Program—has been created under the leadership of the United Nations Environmental Program to implement the commission's work.

While the long-term influence of the WCD remains unclear, its work so far has replaced conflict and confrontation with cooperation and dialogue. But progress was halted when the World Bank, once a strong supporter, announced that it would not recognize the published WCD standards and recommendations as binding for its lending operations. As a result, NGOs are mobilizing to return to the status quo ante. A major breakdown of the post-WCD implementation process would damage similar initiatives in other issue areas. Still, even though the Bank does not officially recognize the standards as binding, its lending practice shows that it cannot ignore the WCD standards.

Thus far, at least, the overall work of the WCD has been deemed a success. Through an inclusive and transparent process, the commission managed to transcend highly volatile and politically sensitive conflicts and to channel social conflict into a productive cross-sectoral dialogue with concrete results. Through extensive consultation and parallel research projects, the commission managed to link the global deliberation process to regional as well as local levels. A balanced approach in financing its work, with equal contributions from foundations, companies, and the public sector, has ensured the impartiality and legitimacy of the WCD to this very day.

Coordination Networks

Coordination networks develop joint plans for action, usually in improving the allocation of scarce resources and correcting market failures in different issue areas.

The Global Water Partnership (GWP), guided by a small secretariat in Stockholm, collects and disseminates best practices and lessons learned in

integrated water management programs. Its central goal is to join all stakeholders from civil society, the private sector, and the public sector into "water partnerships" on the local, national, regional, and global levels. Since its creation in 1996, it has established several regional and almost 20 national water partnerships in Central America, China, South East Asia, and South America, as well as West Africa. Representatives from the private sector, governments, and civil society serve on its board. Funding comes primarily from public sources but also from the Ford Foundation, the UN Development Program, and the World Bank.

The Roll Back Malaria initiative (RBM) was created in 1998 at the behest of the World Health Organization to better coordinate the fight

against malaria, which causes at least 300 million cases of acute illness each year and is the leading cause of death in young children. The initiative's declared goal is to halve malaria-induced mortalities by 2010 by using more effectively the comparative advantages of each actor in the fight.

This new approach is the result of a long and difficult learning process. Over the past 50 years, various international groups have entered the fray, as the problem worsened because of the increasing resistance of malaria vectors, the shift of malaria-endemic regions as a result of global climate change, and increased travel and migration. By the end of the 1990s, the failure of traditional hierarchical approaches had prompted new thinking in the world's health and development communities. Today RBM combines many groups under a single network roof. Companies such as Novartis, ExxonMobil, GlaxoSmith-Kline, and Procter & Gamble are working with NGOs such as Oxfam and the International Federation of the Red Cross, with several national governments lending financial support. The World Health Organization coordinates

the work, with other UN agencies and international organizations also contributing.

Another coordination network, the Medicines for Malaria Venture (MMV), improves the economic incentives for pharmaceutical companies to develop badly needed antimalarial vaccines. Contributors include the Global Forum for Health Research, the Rockefeller Foundation, SmithKline Beecham and Wellcome Trust, and the United Kingdom Department for International Development. Research and development is funded primarily by the public sector and private foundations, creating a more predictable business environment for the pharmaceutical companies that have committed expertise and resources.

Implementation Networks

A final group of networks is dedicated to providing innovative mechanisms for implementing intergovernmentally negotiated treaties. The Global Environmental Facility (GEF), established in 1991, is an early example of a cross-sectoral financial mechanism through which civil society and business implement international agreements on biodiversity, climate change, and persistent organic pollutants.

More recently, the "Clean Development Mechanism" (CDM) and "Joint Implementation" (JI) have been established to help implement the Kyoto protocol on climate change by making use of pollution trading permits. Developing countries and industrialized countries join forces in both CDM and JI, which are designed to scale up cooperative climate-protection projects in fields such as renewable energies, waste management, and carbon sequestration. Developing countries receive financial and other support in the form of foreign direct investment and projects that promote sustainable development; industrialized countries can count certified emission reductions generated by such projects toward their emission accounts established under the protocol. The goal is to create new incentives for investment in climate-friendly technologies and to open new channels for technol-

The new cross-sectoral networks are confronting issues that no single sector, public or private, could successfully tackle alone.

ogy transfer to the developing world. Both JI and CDM projects offer new venues for the private sector and civil society to participate in climate-protection projects. The projects typically bring together one or more countries committed to reduce emissions under the Kyoto protocol, companies from these countries that wish to buy emission reductions, a host country that approves the project and the purchase of trading permits, and a project developer (a company or an NGO).

NGOs can help design projects and implement them on the local level, serving as watchdogs and helping tailor projects to community needs. Cooperation between the public sector, companies, and NGOs on global warming is often highly charged, however, complicating further the work of these networks in promoting sustainable development.

Management Challenges

Networks do not offer a free lunch. They are complex political animals that require much political skill and leadership to be successful and sustainable in the long term. As with any new form of governance there is no shortage of crucial shortcomings and challenges, which critics have pointed out in recent years and which networks have already responded to in various ways.

Although the degree of inclusion of stakeholders is critical to a network's legitimacy, large numbers of participants may result in sizable, sometimes prohibitive, transaction costs. Furthermore, mutual dependence and long-term interaction may lead networks to develop into closed shops. And the need for compromise and consensus might favor the lowest common denominator as the eventual policy outcome. At the same time, networks' informal structure and reliance on consensus may offer decision blockades and veto positions for even their smallest actors.

Global public policy networks have been criticized most often—and on most fronts—for unequal access and power. Many in the developing countries believe the networks are dominated by the industrialized nations, whose

corporate and civil society interests further weaken the already feeble voices of the poor countries. Other critics castigate the network approach for its “power blindness” and its naivete in the face of huge power disparities in the global arena. Parliamentarians also often feel bypassed by networks in which representatives from the executive branch mostly take the lead. Finally, some critics have noted in these networks a tendency to act as talk-shops that consume resources—tangible as well as intangible—without delivering adequate results.

All these issues must be addressed to mainstream cross-sectoral networks in global policymaking. It is promising that a number of networks have found innovative ways of dealing with these complicated issues, such as balancing representation or transparency requirements.

Learning by Doing

In his Millennium Report, UN Secretary-General Kofi Annan noted that “if we are to get the best out of globalization and avoid the worst, we must learn to govern better, and how to govern better together. . . . We must form coalitions for change, often with partners well beyond the precincts of officialdom. . . . Mobilizing the skills and other resources of diverse global actors, therefore, may increasingly involve forming loose and temporary global policy networks that cut across national, institutional and disciplinary lines.” Cross-sectoral networks are a promising means to improving global governance. But much remains to be done if the networks are to live up to their potential. Three tasks are central.

The first is to mainstream cross-sectoral networking by promoting organizational change. The UN and the World Bank have declared their intention of making partnerships and “coalitions for change” a central part of their strategic orientation. But the involvement of international organizations in partnerships remains scattered, and public institutions often lack a coherent strategy to incorporate partnerships into their “normal” way of doing business (as do many businesses and NGOs).

Increased involvement by multilateral institutions will require big changes in their organizational structures and cultures. It will also require fundamental change on the side of their stakeholders—governments of their member states. Networks and partnerships are meant to complement, not replace, national governments. They are not intended to let governments “off the hook.” States must be willing to invest substantial resources into these new forms of governance. In return, networks can help states and their international organizations achieve their missions, maintain their competence, and serve their citizens.

The second task is to strengthen network accountability. While a binding legal framework for cross-sectoral networking is neither realistic nor desirable, it is possible to devise ground rules that foster the accountability of network participants and processes.

The final task is to build capacity through a learning forum. One way to make the most of these new forms of governance is to create a “learning forum” to connect work being done on cross-sectoral collaboration in think tanks, NGOs, companies, international organizations, and public-sector agencies. The learning forum should bring together the rigor of policy analysts and the wealth of experience of network practitioners to discuss best practices and lessons learned. It could devise ways to scale up networks' experience, increase their resources, and monitor and evaluate their work. It could also provide training services for networks.

The past decade has been a period of ferment and experimentation with new cross-sectoral forms of governance in global policymaking. In many ways, practice can now inform theorizing. Global public policy networks require political leadership, organizational reform on the part of all involved, and the commitment of real resources. Given the magnitude of governance challenges we are facing today, we need to make sure to capitalize on the rich experience of cross-sectoral networks and fully put them to work for improving global governance. ■

ASYMMETRIC

Global

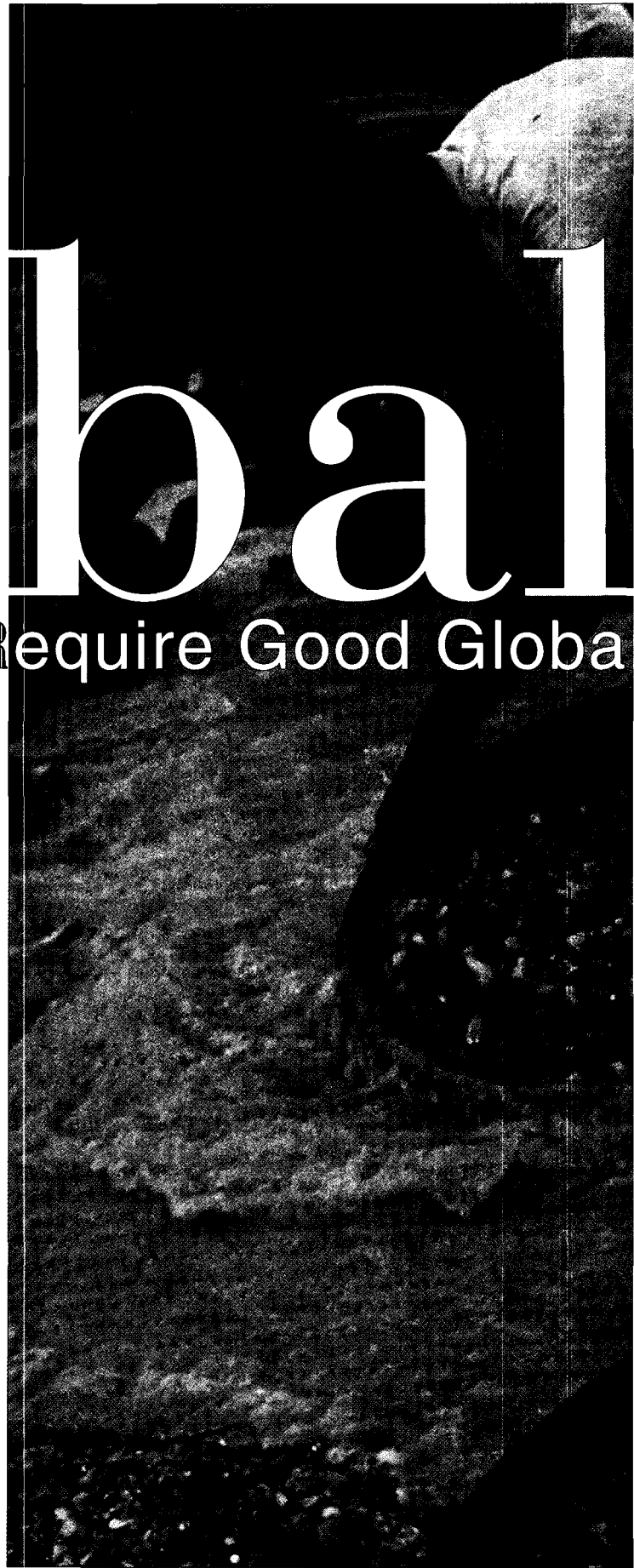
Global Markets Require Good Global

By Nancy Birdsall

The globalization of markets can benefit—and has benefited—rich and poor alike. But the integration of the global economy is outpacing the development of a healthy global polity. To realize the values and rules critical to a secure and just world—and to make the full benefits of a global market available to all—will require a better global politics.

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CHRIS HONDROS/GETTY





Workers pan
for diamonds
in Sierra Leone.
Diamond panners
typically earn 25
cents and two
cups of rice a
day.

ization

Politics

The debate about the implications of market-led globalization for the poor has taken on new urgency in the past several years. On one side are most mainstream economists, international institutions such as the United Nations and the World Bank, most finance ministers and central bank governors in poor and rich nations alike, and most professional students of development. They argue that globalization is not to blame for any increase in world poverty and inequality—and point out that the world's poorest people, those living in rural Africa and South Asia, are those least touched by globalization. On the other side of the debate are most social activists, members of nonprofit civil society groups who work on environmental issues, human rights, and relief programs, most of the popular press, and many sensible, well-educated observers. To them, the issue seems self-evident. Globalization may be good for the rich countries and the rich within countries, but it is bad news for the poorest countries and especially for the poor in those countries.

One central issue is whether the current distribution of economic and political power in the world is just or fair—whether it provides for equal opportunities to those who are poor and, in global affairs, relatively powerless. On this score, I believe it is time for the first group to internalize the arguments of the second and recognize the need for an improved global politics, in which more democratic and legitimate representation of the poor and the disenfranchised in managing the global economy mediates the downside of more integrated and productive global markets.

Globalization, Poverty, Inequality

Most developing countries began to be tied into the world economy only in the 1980s. Before that, although they participated in some multilateral trade agreements, special preferences permitted them to protect their own markets. In the 1980s, however, and increasingly in the 1990s, most developing countries took steps to open and liberalize their markets. In addition to reducing and eliminating tariffs and nontariff barriers, they made fiscal and monetary reforms, privatized and deregulated their economies, eliminated interest rate ceilings, and, in the 1990s, opened capital markets—a package that came to be known as the Washington Consensus. These market reforms and accompanying, often socially painful, structural changes were encouraged and supported by the International Monetary Fund, the World Bank, and the U.S. Treasury with large loans typically conditioned on countries' adopting and implementing agreed policies. The increasing reliance on markets in the developing world and, in the 1990s, in the countries of the former Soviet empire is with good reason seen as part and parcel of globalization. And because of the conditioned loans, many opponents of globalization today see the turn to the market—and thus to global capitalism—as imposed on the developing countries. (Ironically, the loans often were disbursed even when agreed conditions were not implemented.)

With the growing influence of markets in the past two decades have come changes in global inequality and world

poverty. Over the past century, global inequality by most measures has been growing. At the end of the 19th century, the ratio of the average income of the richest to the poorest country in the world was 9 to 1. Today the average family in the United States is 60 times richer than the average family in Ethiopia or Bangladesh (in terms of purchasing power). The increase in inequality is the result of a simple reality. Today's rich countries, already richer 100 years ago (thanks to the Industrial Revolution), have been blessed with economic growth and have gotten a whole lot richer. Poorer countries, poor to start with, have grown little if at all.

In the past two decades, the picture has changed a bit. Some developing countries, including China and more recently India, have grown faster than the already rich countries. Incomes in China and India will not soon equal those in rich countries—it would take them almost a century of faster growth even to reach current U.S. levels. Still, some developing countries have done some dramatic catching up.

And the rapid growth in India and China has caused world poverty to decline. Between 1987 and 1998, the share of the world's population that is poor (using World Bank figures and the Bank's poverty line of \$1 a day in 1985 dollars) fell from about 25 percent to 21 percent; the absolute number fell from an estimated 1.2 billion to 1.1 billion. The decline was concentrated in India and China; elsewhere in the developing world, numbers rose.

Measured in yet another way—by a “world” distribution of income that ranks all individuals or households around the world according to income, giving each person (or household) the same weight in the distribution—world inequality is extremely high but is leveling off. Although today the richest fifth of world households is about 25 times richer than the poorest fifth, in the past 20 years the rapid growth of India and China has slowed increases in world inequality. (The world distribution of course gives much greater weight to these high-population countries.)

At the world level, then, it is fair to say that poverty is declining and inequality is not increasing. Today's global inequality is mostly a matter of differences between rich and poor countries in past rates of growth. That brings us back to the main argument of globalization's proponents: countries that have successfully entered the global market and participated in globalization have grown most. Historically, that included Japan, beginning in the Meiji era between 1868 and 1912, the poorer countries of Western Europe during the 19th century and then again after World War II, and the so-called miracle economies of East Asia between about 1970 and 1998. More recently, it has included China and India, as well as Bangladesh, Brazil, Malaysia, Mexico, Mozambique, the Philippines, Thailand, Uganda, and Vietnam. Poverty remains highest in the countries, including many in Africa and some in South Asia, and among people, especially in the rural areas of China, India, and Latin America, that are marginal to global markets. To the extent that globalization has “caused” increasing inequality, it is not because some have benefited a lot—a good thing—but because others have been left out altogether.

Globalization Is Not the Solution

But if globalization is not the cause, neither is it the solution to the world's continuing poverty and haunting inequality. Consider the plight of many of the world's poorest countries. Highly dependent on primary commodity and natural resource exports in the early 1980s, they have been "open" for at least two decades, as measured by their ratio of imports and exports to GDP. But unable to diversify into manufacturing (despite reducing their own import tariffs), they have seen the relative world prices of their commodity exports fall—and have been left behind. Despite rising exports, tariff reductions, and market-oriented reforms including greater fiscal and monetary discipline and the divestiture of unproductive state enterprises, they have been unable to increase their export income, failed to attract foreign investment, and grown little if at all.

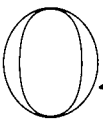
Many of these countries in sub-Saharan Africa, as well as Haiti, Nepal, and Nicaragua, seem trapped in a vicious circle of low or unstable export revenue, weak and sometimes predatory government, terrible disease burdens (the HIV/AIDS pandemic being only one recent example), and failure to deliver to their children education and the other services that are critical to sustainable growth. For these countries, despite efforts by their governments to enter global markets, globalization has not worked. Success in global markets might come with success in growth and development itself, but it is not likely to come on its own.

For better-off emerging market economies, globalization has failed to work in a second way. For them global trade has been generally a boon, but global financial markets pretty much a bust. In the past decade, Mexico, Korea, Thailand, Indonesia, Russia, Brazil, Ecuador, and Turkey, and this year Argentina, were all hit by financial crises triggered or made worse by their exposure to global financial markets. Weak local financial markets and wary local and foreign creditors made these countries highly vulnerable to the panicked withdrawal of capital typical of bank runs. And the resulting financial instability was especially costly for the working poor and the emerging middle class. In Turkey, Argentina, and Mexico, hit repeatedly by inflation and currency devaluations in the past two decades, wealthy citizens move substantial financial assets abroad, often simultaneously acquiring bank and corporate debt that is then socialized and paid by taxpayers, worsening inequality—and certainly appearing unfair. In parts of Asia and much of Latin America, inequality had already increased during the mid-1990s boom as portfolio inflows and high bank lending fueled demand for assets, such as land and stocks, owned by the rich.

In both regions the poor and working class gained the least during the boom and then lost the most, certainly relative to their most basic needs, in the post-crisis bust. The high interest rates that the affected countries used to stabilize their curren-

cies also hurt most small capital-starved enterprises and their low-wage employees. The bank bailouts that often follow financial crises create public debt that again implies a transfer from taxpayers to rentiers. China and India, whose capital markets remained relatively closed, survived the financial crises of the late 1990s better than did Mexico, Argentina, and Thailand. More open trade is good for growth and benefits the poor, but the effects of the rapid and near-complete opening of capital markets pushed by the IMF and the U.S. Treasury throughout the 1990s were not so benign. No wonder social activists are suspicious of corporate and financial influence in global markets.

A third problem with globalization has been that privatizing and liberalizing financial markets in the absence of adequate regulatory institutions and banking standards and supervision invite corruption. Russia is only the most visible example. Open capital markets make it easier for corrupt leaders to burden their own taxpayers with official and private debt while padding their own foreign bank accounts. Unregu-



pportunities in
the global economy
are not equal.

lated markets make money laundering and tax evasion easier and raise the costs asymmetrically for poor countries to defend their own tax systems. Global capital markets do not cause all these problems, but like an occasion of sin they increase the likelihood that human failings will corrupt the system, usually at a cost to the poor and powerless.

Unequal Opportunities

Not all the suspicions of the activists are necessarily warranted. But the activists are right in one important respect. The opportunities in the global economy are not equal.

In the global market, those without the right training and equipment can easily lose. That is because markets that are bigger and deeper reward more efficiently those countries and those people who already have productive assets. For people the relevant assets include financial, physical, and, perhaps most crucial today, human capital. For countries what matters are healthy and stable country institutions—established political systems, secure property rights, adequate banking supervision, reasonable public services. It is no accident that 80 percent of all foreign investment occurs among the industrialized countries—and that just 0.1 percent of all U.S. foreign investment went to sub-Saharan Africa last year.

At the individual level, the best example of how healthy markets can generate unequal opportunities is the rising returns to higher education throughout the world. In the high-tech global economy, the supply of university-educated people has not been keeping up with ever-increasing demand, leading to wage gains for college graduates and wage losses for those with high school education or less. Just about everywhere in the world (Cuba, China, Kerala state in India, all socialist entities being exceptions), education reinforces initial advantages instead of compensating for initial handicaps.

The global market for skilled and talented people is another illustration of the asymmetrical effect of markets. The highly skilled are highly mobile. Indian engineers can quadruple their earnings by moving from Kerala to Silicon Valley. For the individuals concerned, this “brain drain” is a good thing, and eventually it can generate offsetting remittances and return investments if the institutional and policy setting in India and other poor countries improves. But in the short run, it makes it harder for the poorer countries to build those institutions and improve those policies. The annual loss to India of its brain drain to the United States is estimated at \$2 billion. The farmers and workers whose taxes finance education in poor countries are subsidizing the citizens of the rich countries—whose tax revenues are boosted by the immigrants’ contributions.

The efficiency gains and increased potential for growth of a global market economy are not to be disdained. Rising wage gaps in open and competitive markets should not surprise or alarm us: they may be the short-term price worth paying for higher long-run sustainable growth. They create the right incentives for more people to acquire more education, in principle eventually reducing inequality. But in modern market economies, a well-defined social contract tempers the excess inequalities of income and opportunity that efficient markets easily generate. Progressive tax systems provide for some redistribution, with the state financing at least minimal educational opportunities for all and some social and old-age insurance. There is no global analogue.

When the Market Fails

Global market failures also raise new costs for the vulnerable and compound the risks faced by the already weak and disadvantaged. The rich countries that historically have the highest per capita greenhouse gas emissions have not internalized the costs of their pollution but have imposed them on the poor countries, whose citizens have few resources to protect themselves.

Financial contagion across countries, affecting even those emerging market economies with relatively sound domestic policies, can also hit hardest the already vulnerable. Financial contagion has not only brought instability and slower growth to Latin America and East Asia; it has weakened their capacity to develop and sustain institutions and programs to protect

their own poor. With global market players doubting the commitment of nonindustrialized countries to fiscal rectitude at the time of any shock, countries are forced to tighten fiscal and monetary policy to reestablish market confidence, rather than stimulate their economies to combat recession. These austerity policies are the opposite of the policies the industrial economies implement—reduced interest rates, unemployment insurance, increased availability of food stamps and public works employment. All these are fundamental ingredients of a modern social contract. And the effects of unemployment and bankruptcy can be permanent for the poor. In Mexico, increases in child labor that cut school enrollment during the 1995 crisis were not reversed: some children did not return to school when growth resumed.

Contagious diseases, transnational crime, and potentially beneficial but risky new technologies such as genetically modified foods also entail asymmetric costs and risks for poor countries and poor people. Similarly, poor countries that protect global resources such as tropical forests and biological diversity are paying the full costs but are unable to capture the

Those concerned
with global justice face
a daunting problem
of global collective action.

full benefits of these global goods. Within countries, governments temper market failures through regulations, taxes and subsidies, and fines; and they share the benefits of such public goods as security, military defense, management of natural disasters, and public health through their tax and expenditure decisions. Ideally those decisions are made in a democratic system with fair and legitimate representation of all people, independent of their wealth. In nations, such political systems seldom work perfectly. In the global community, a comparable political system just barely exists.

Economic Power and Global Rules

Unequal opportunities for the poor, and the risk they bear when the market fails, are not the whole story. In the global game, economic power matters. The rich and powerful can influence the design and implementation of global rules to their own advantage. Political constraints in rich and powerful countries dominate, for example, the design of global trade rules. The resulting protection in the United States and Europe of agriculture and textiles—both sectors that could generate jobs for the unskilled—locks many of the world’s poorest countries out of potential markets. The U.S. African Growth and Opportunity Act and the European Union’s

recent initiative to eliminate all barriers to imports from the world's 49 poorest countries are steps in the right direction—but very small steps indeed since the countries that can benefit make up only a minuscule proportion of all world production. And even those initiatives were watered down considerably by domestic political pressures and include complicated rules that create uncertainty and limit big increases in poor-country exports.

Political constraints also affect the way trade rules are implemented. Complicated negotiations and dispute resolution put countries with limited resources at a disadvantage. The use of antidumping actions by U.S. producers, even when they are unlikely to win a dispute on its merits, creates onerous legal and other costs to producers in developing countries and chills new job-creating investment in affected sectors. About half of antidumping actions are directed against developing country producers, who account for 8 percent of all exports.

International migration too is governed by rules stacked against the developing countries, especially their poor and unskilled citizens. Permanent migration has slowed because higher-income countries restrict immigration. In the 25 years before World War I, 10 percent of the world's people changed their permanent country residence; in the past 25 years, that figure has fallen to 2 percent. Yet just as the huge influx of Europeans to the Americas in the 19th century reduced inequality, more migration today would do the same. An auto mechanic in Ghana can quintuple his income just by moving to Italy. During the recent information technology boom, the United States allowed highly skilled workers to enter with temporary visas—a boon, no doubt, for the beneficiaries, but also a drain on the working taxpayers in poorer countries who helped educate them and yet another example of the capacity of the already rich to exploit their power.

Economic power also affects the rules and conduct of the international institutions. The International Monetary Fund is meant to help countries manage macroeconomic imbalances and minimize the risks of financial shocks. But in the 1990s the IMF, heavily influenced by its richer members, was too enthusiastic in urging developing countries to open their capital accounts. Even when the policies supported by the IMF and the World Bank have made sense—and I believe for the most part they have—the policymakers have no real accountability to the people in developing countries most affected by them. Developing countries are poorly represented in these institutions' voting and other forms of governance.

A New Agenda of Good Global Politics

That poverty is declining worldwide and inequality is leveling off are not signs that all is well in our new globalized economy. Proponents of market-led globalization must recognize that the global economy is not addressing the problems of poverty and inequality and is ridden with asymmetries that add up to unequal opportunities. Social activists must rethink their demands for dismantling the limited institutions for managing globalization's downside. Both groups must join

forces to push a new global agenda, aiming for a new global politics to accompany the global economy.

Statements of social and economic rights in the United Nations and relatively minor transfers of financial and technical resources from rich to poor countries are as close as we have come to anything like a global social contract. Anyone arriving from another planet into our highly unequal global economy would have to conclude that rich countries have no interest in doing anything much to help the poor in poor countries—surprising given what could be their enlightened self-interest in a more secure and prosperous global economy. The logic of a global social contract is clear, but it cannot be constructed out of nothing. As is the case within countries, a social contract involves some transfers—for investments in the human capital and the local institutions that can ensure equal opportunities for the poor.

Past mistakes in foreign aid policy—multiple and onerous standards of different donors, conditionality that doesn't work—should not be an excuse for the rich countries' minimal spending on foreign aid. With many poor countries consolidating reforms, their ability to spend resources productively now far exceeds the amount of aid available. In the industrialized economies, domestic social contracts—public transfers for investing in education, health, and housing and for social-safety-net programs such as unemployment and disability insurance and welfare and pension programs—usually amount to more than 10 percent of GDP. Foreign aid for a global social contract is below 0.5 percent of rich countries' combined GDPs.

Most important, the global and regional institutions that are the world's most obvious mechanisms for managing a global social contract must be reformed, not dismantled. It is ironic that the World Bank and the IMF have been the lightning rods for antiglobalization protests. Accused of being too powerful, they may well be too limited in their resources and insufficiently effective to manage a global contract that would bring equal education, health, and other opportunities to the poor in poor countries. Making these institutions more representative and more accountable to those most affected by their programs, and thus more effective, has to be on the agenda of better global politics.

That agenda must also include opening rich-country markets to developing countries and rethinking the rich world's restrictions on immigration of the unskilled. Developing countries should also be more fully and fairly represented in international institutions, especially the financial institutions, whose policies and programs are so central to their development prospects.

Those concerned with global justice, whether economists and finance ministers or activists, face a daunting problem of global collective action. They need to make a common agenda for a global social contract. In practical terms that means working together in the short run to build a more level playing field in global governance. It means insisting that a new global development architecture be based on good global politics and not just expanded global markets. ■

At the beginning of 2002, Enron was the seventh largest company in the United States, with operations extending worldwide. Telecommunications giant Global Crossing operated in 27 countries and 200 cities on five continents. But both fell last year under the weight of financial problems created by the self-dealing of a few corporate insiders and masked by nontransparent accounting. These and other similar corporate failures deprived millions of company employees and shareholders of their lifetime savings and retirement benefits. Stock prices of other U.S. companies also took a beating, partly in response to the revelation of these scandals.

Since January 2002, all major U.S. stock indexes have plummeted. NASDAQ fell almost a third in 2002, and the Dow and S&P 500 tumbled for the third consecutive year, the longest downturn since 1939-41. Foreign markets have also been hit with big losses. Japan's Nikkei 225 closed down 18.6 percent for the year; Britain's FTSE 100, down 24.5 percent.

discuss two. One is insider trading—the buying and selling of stock by people who possess nonpublic information relevant to its price. As recent work by Julian Du of the Chinese University and one of the authors (Wei) has shown, insider trading can affect stock prices—and even more important, economic performance—around the world.

Stock markets are volatile. That is not news. But volatility varies greatly from one country to the next. Measured by the standard deviation of the monthly returns of a major market index, stock market volatility is almost twice as high in Italy as it is in the United States. Markets in developing countries are typically even more volatile. The Chinese market is three and a half times more volatile than the U.S. market; the Russian market, six and a half times more volatile.

Excessive volatility matters because it affects people's incentive to save and to invest. In almost any economic model with a representative investor, the more volatile the asset market, holding the average return constant, the less the investor will save and hence invest. A certain degree of market volatility is unavoidable, even desirable. Ideally,

A Global Crossing

Of course, the burst of the dot-com bubble, the uncertainty about a war in the Middle East, and a possible rise in oil prices may all have contributed to the stock price decline. It is only natural, however, to suspect that “Enronitis”—opaque self-dealing by a few insiders—has also contributed to this meltdown of the financial markets around the world. In this article, we provide some evidence to substantiate the suspicion.

Roller Coaster Rides

Enronitis has many symptoms. Here we

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changing stock prices signal changing values across economic activities and thereby improve the way resources are allocated. But volatility that is unrelated to market fundamentals results in confusing signals that hamper resource allocation. To the degree that insider trading affects the volatility of a country's stock market, it could thus also affect that country's economic performance.

Some analysts think that because insider trading allows relevant information to be reflected in the stock price faster than it otherwise would be, it should reduce market volatility and improve economic efficiency. That view, however, fails to take into account the ability of insiders to take actions to

maximize personal benefits. Access to inside information is most valuable when prices are either rising or falling dramatically. So people in the position to possess inside information love market volatility, and they realize that their actions can increase volatility—through two channels. First, if insiders have a choice of projects or technologies, they may choose the riskier ones. Second, even holding the risk of the technology or project constant, insiders have an incentive to manipulate the timing and content of the information release in a way to maximize volatility.

National laws and enforcement regarding insider trading differ widely around the world. The set of activities



Or Enronitis? How Opaque Self-Dealing Damages Financial Markets around the World

By Shang-Jin Wei with Heather Milkiewicz

defined as illegal can vary, as can the penalties and the diligence with which laws are enforced and lawbreaking punished. In the United States, for example, insider trading is a criminal offense with penalties including jail terms. In Hong Kong insider trading is a civil violation whose maximum penalty is a fine. But Hong Kong compensates for that light penalty with tight antifraud regulation and relatively rigorous and predictable law enforcement. Government regulators are well trained, professional, and relatively incorrupt. Despite the light penalty, corporate insiders in Hong Kong would think twice before releasing misleading information or committing financial fraud.

As insider trading is an opaque practice, difficult to measure and compare across countries in a precise way, few economists have studied it empirically. Recently, a new measure of insider trading was established in a survey of business executives by Harvard University and the World Economic Forum. Using this measure, Du and Wei have shown that more insider trading is related to a higher market volatility. Statistical analysis of the data in table 1 reveals that a rise in insider trading from a relatively low level, such as that in the United States (2.62 on a scale from 1 to 7), to a relatively high level, such as that in China (4.62), would increase the volatility of stock returns by 2.5 percentage points

(that is, stock volatility would go up from 4 percent to 6.5 percent)—a sizable increase. In comparison, the difference in the volatility of GDP growth rates for the United States and China increases Chinese stock volatility by only 1 percentage point. In other words, China's higher stock market volatility is explained more by excessive insider trading than by the higher volatility of its economic fundamentals.

Correlation, of course, does not necessarily imply causality. But further statistical analysis by Du and Wei shows that the link between insider trading and market volatility most likely is causal—that is, an increase in insider trading leads to a rise in stock market

volatility. And insider trading is associated with a higher market volatility even after other possible causes of market volatility—the volatility of the real output growth, volatility of monetary and fiscal policies, and maturity of the stock market—are taken into account.

The clear lesson here is that to rebuild confidence in their financial markets—and to encourage saving and investment by their citizens—countries with a high degree of insider trading must strengthen their regulation of insider trading and enforce existing regulations more rigorously.

Lack of Transparency

Another symptom of Enronitis is a lack of transparency in corporate and government operations. The recent wave of corporate scandals in the United States has thrown open some corporate curtains to reveal numerous once-secret activities. But many countries the world over have even more serious deficiencies in transparency—not only in their corporations but in their governments—that have retarded their ability to attract international portfolio investment, as research by Gaston Gelos of the International Monetary Fund and one of us (Wei) has shown.

In fact, policymakers often cite lack of transparency as one cause of the financial crises in emerging markets in Asia and Latin America over the past decade. A recent IMF report, for example, noted that a “lack of transparency was a feature of the buildup to the Mexican crisis of 1994–95 and of the emerging market crises of 1997–98.” The report concluded that “inadequate economic data, hidden weaknesses in financial systems, and a lack of clarity about government policies and policy formulation contributed to a loss of confidence that ultimately threatened to undermine global stability.” The international financial institutions have actively promoted more transparency among their member countries and are also aiming for more transparency in their own operations.

We use the term “transparency” to denote both availability and quality of information at the country level. In

government, transparency refers not only to the availability (both timeliness and frequency) of macroeconomic data but also to the conduct of macroeconomic policies. Corporate transparency refers to the availability of financial and other business information about firms.

In principle, for investment across countries, just as for investment across corporations within a country, greater transparency levels the playing field for all investors, increasing their collective confidence and thus encouraging investment. Most technical studies, however, have not demonstrated rigorously this intuitive insight.

To be able to say whether international mutual funds invest less in less transparent countries, one needs to know how much these funds would have invested in various countries had all the countries been the same on the transparency dimension. A useful benchmark is the index produced by Morgan Stanley Capital International, which essentially documents the share of a country's stock market assets in the world stock market.

Table 2 shows measures of opacity—the opposite of transparency—for both government and corporate operations

Table 1.
Market Volatility and Insider Trading, Selected Countries

COUNTRY	STOCK MARKET VOLATILITY	GCR INSIDER TRADING INDEX
Australia	0.077	2.57
Brazil	0.182	4.24
Chile	0.081	3.64
China	0.146	4.62
Denmark	0.054	2.11
Egypt	0.075	4.21
France	0.063	3.07
India	0.093	4.53
Mexico	0.140	4.49
Russia	0.285	4.63
Turkey	0.183	4.08
United Kingdom	0.056	2.26
United States	0.043	2.62
Zimbabwe	0.109	4.14

Source: Condensed from Du and Wei (see box on page 31). The insider trading index originally is derived from the *Global Competitiveness Report* in 1997 and 1998. (The insider trading index = 8 – the average of the original index.) A higher number implies a higher degree of insider trading. Market volatility is the standard deviation of the monthly returns in U.S. dollars over 1984.12–1998.12.

Table 2.
Opacity Measures, Emerging Market Countries

COUNTRY	O-FACTOR (COMPOSITE)	MACRO-ECONOMIC DATA OPACITY	MACRO-ECONOMIC POLICY OPACITY	CORPORATE OPACITY
Argentina	40	0.20	2	3.13
Brazil	34	0.11	2	3.03
China	-	1.87	7	4.23
Egypt	39	1.81	6	3.66
Greece	37	1.55	-	3.13
India	38	1.45	4	3.22
Indonesia	47	0.71	4	3.83
Korea	42	1.00	3	3.25
Mexico	33	0.32	3	3.36
Peru	38	0.46	3	3.39
Russia	55	0.34	5	4.21
Singapore	22	0.84	-	2.06
Turkey	46	0.50	5	2.89
Venezuela	42	0.90	6	4.28
Zimbabwe	46	1.40	-	3.17

Sources: Condensed from Gelos and Wei (see box on page 31). O-Factor is derived from a PricewaterhouseCoopers survey of banks, firms, equity analysts, and in-country staff in 2000; Macroeconomic Data Opacity is based on indices on the frequency and timeliness of national authorities' macroeconomic data dissemination computed by Peter Allum and Agca Mehmet at the IMF, averaged over 1996, 1997, and 2000; Macroeconomic Policy Opacity is based on measures developed by Oxford Analytica for Wilshire Associates (ratings for transparency of fiscal and monetary policies, on a scale 1–10, where 10 is the least transparent); Corporate Opacity is created using results from surveys about the level of financial disclosure and availability of information about companies from the *Global Competitiveness Report* produced by the World Economic Forum and Harvard University's Center for International Development, averaged over 1999 and 2000. Hyphens indicate that data are not available.

for 15 emerging market countries. (A higher rating is associated with more opacity.) Statistical analysis of the data in the table suggests that a lack of transparency, using any measure, is associated

with less investment by international mutual funds. A country like Venezuela, for example, would quadruple its portfolio holdings if it increased its transparency to Singapore's level. The prospect of such an increase in portfolio holdings should strongly encourage countries to undertake reform to improve transparency.

Aside from the level of investment, trading patterns by foreign investors would affect the volatility of the market. At least since the Asian financial crisis, analysts have seen "herding"—international investors' tendency to mimic each other's behavior, sometimes ignoring useful information—as one contributor to market volatility in developing countries. Although in economic theory the relationship between transparency and herding is not clear-cut, our research has uncovered evidence of a positive association between a country's lack of transparency and international investors' tendency to herd when investing in its assets. Thus, if herding by international investors raises volatility or causes more frequent financial crises in emerging markets, it is related to these countries' transparency features.

Another key question is whether capital flight during a time of currency and financial crisis is related to lack of transparency. Do differences in transparency, above and beyond macroeconomic indicators of a country's economic health, explain why some countries suffer greater confidence loss than others during turbulent times?

The Gelos-Wei research suggests that more opaque countries do suffer larger outflows during crises. During the Asian and Russian crises, capital exodus was greater in less transparent countries. So, in a concrete sense, lack of transparency worsens the crises in some countries.

Wanted: Fair Play

It is not easy to restore confidence in financial markets where fraudulent and illegal practices within corporations have run rampant and where a government's operations are not transparently accountable to its citizens. And it will not happen overnight. Even the United

States, once the world's unquestioned leader in attracting international funds, cannot bounce back immediately. More than a year after the onset of the 2002 corporate scandals Wall Street is still trying to regain its preeminence in the financial world—and to regain the trust of its many disillusioned investors, both at home and abroad.

In the United States, both individuals and the government have made efforts to restore the credibility of the market and assure the public that the nation is serious about eliminating foul play within corporations. Shortly after the Enron scandal became public, policymakers proposed many initiatives to improve monitoring practices within corporations. Congress has passed legislation designed to eliminate fraudulent behavior in corporations through more careful supervision and the release of greater information to investors. The Securities and Exchange Commission has renewed its efforts to reform existing regulations and create new ones.

The United States is not alone in sensing the need for corporate governance reform. The financial crises of the 1990s spurred such reforms throughout Asia and Latin America. Corporate and government opacity is a major issue in many countries in Latin America, largely owing to the prominence of family-owned companies and the extent of government intervention. Legislation that was passed recently in Chile to increase protection and give more rights to minority shareholders can serve as an example for other countries in the region.

In Asia, a minority shareholders' movement launched in Korea in 1998 has raised awareness of the importance of corporate governance. The shareholders' movement has also created a research center to investigate corporate misbehavior.

China's government has resisted making immediate national reforms, preferring instead to set up a special governance zone (SGZ) in Shenzhen to experiment with anticorruption reforms. A successful reform program in Shenzhen can serve as a model for the rest of the country, but the signifi-

cance of the experiment goes beyond that. Antireform bureaucrats in China often resist international best practices by claiming to have "a different culture," "a different history," or "a different tradition." Once anticorruption reform succeeds in one SGZ, reform-resistant officials will have fewer excuses for refusing to push for reform. Successful anticorruption reform will also help galvanize popular demand for larger-scale administrative reform in China.

Alongside these individual country efforts, the International Monetary Fund, the World Bank, and other international institutions have become more aggressive in assessing the adequacy of existing standards and codes of financial supervision and the conduct of fiscal and monetary policies in their member countries. They have also become more insistent in advocating the international best practices in these areas.

None of the reforms so far can claim complete success; perhaps they never will. But the revelations of corporate scandal in the United States and the financial crises in the developing countries have persuaded many people around the world that Enronitis, in its various guises, can seriously damage people's confidence in a financial system and slow economic development. If one positive thing has come out of the Enronitis epidemic, it is the reinvigorated reform effort worldwide to reduce the chance of a future economic devastation resulting from poor public and corporate governance. ■

For Further Reading

Julian Du and Shang-Jin Wei, "Does Insider Trading Raise Market Volatility?" (Brookings, December 2002).

<http://www.brookings.edu/scholars/swei.htm>.

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ODIOUS DEBT

When Dictators Borrow, Who Repays the Loan?

By Michael Kremer
and Seema Jayachandran

When the international community wants to put pressure on a government that suppresses democracy and human rights, it commonly imposes economic sanctions. Traditional sanctions, however, are often either ineffective or inhumane. Targeted governments find ways around the sanctions, which offer third parties—smugglers and even other national governments enticed by the promise of large profits—incentives to evade them. And when the sanctions work, they often harm the targeted government's people, impoverishing them further through the loss of national income. We propose a new form of sanction—a loan embargo.

Unlike a trade sanction, a loan embargo would be self-enforcing. Not only would it not offer third parties incentives to evade it, it would eliminate the existing incentive of some creditors—banks, bondholders, or governments—to collude with dictators, issuing loans that enrich themselves. Because a loan embargo would be self-enforcing, it would be more effective than trade sanctions—and thus could help pressure dictators to undertake needed reforms by limiting their ability to borrow abroad and then loot borrowed funds—or use the funds to finance the repression of their people. At the same time, a loan embargo would protect the people's interests by freeing them of the obligation to repay the accumulated debts after they finally rid themselves of their illegitimate government. The key to a loan embargo is a concept known as “odious debt.”

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Odious Debt

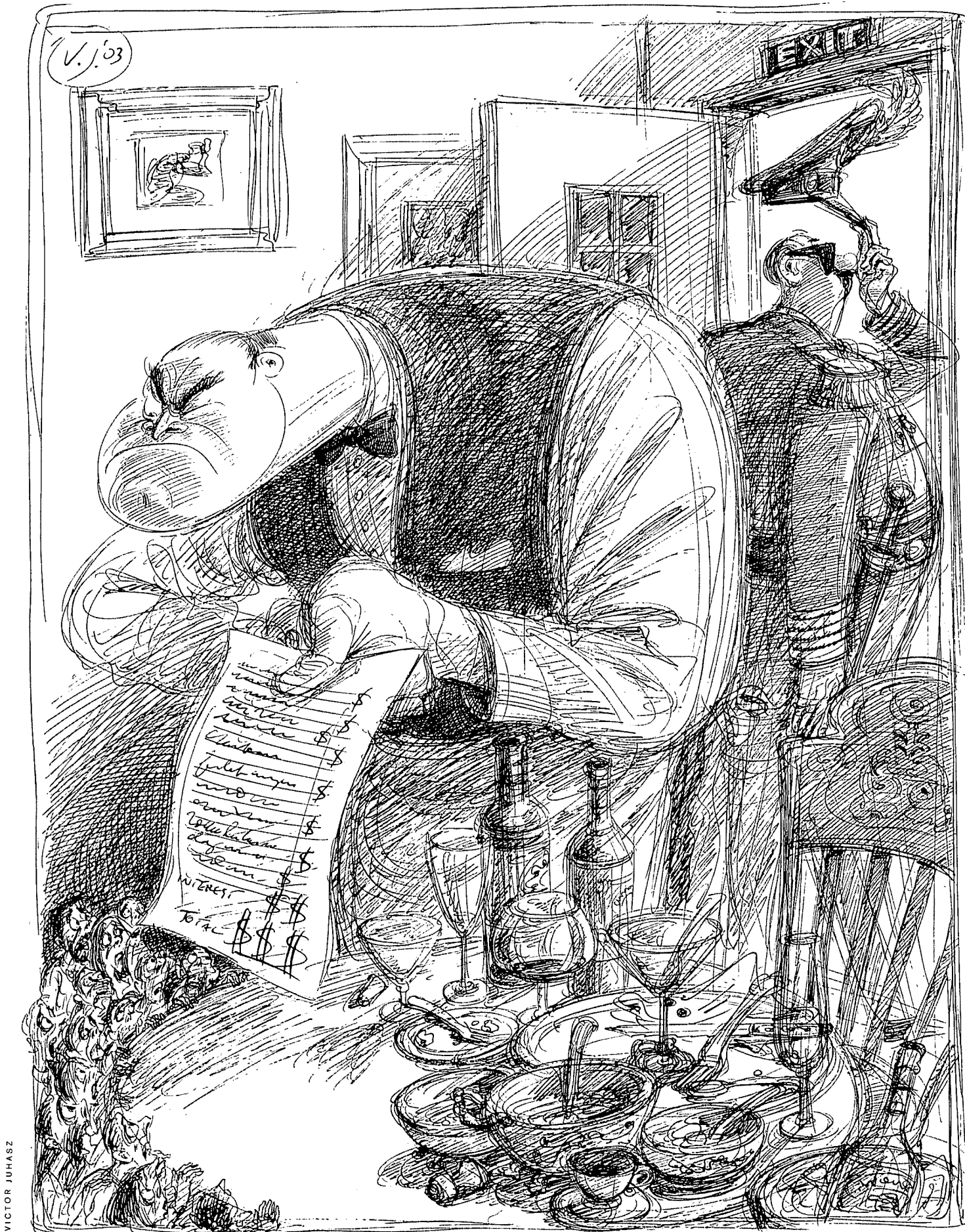
By law, in most countries, individuals do not have to repay money that others fraudulently borrow in their name. Similarly, a corporation is not liable for contracts that the chief executive officer enters without the authority to bind the firm. But international law does not exempt citizens of a dictatorship from repaying a debt incurred by a dictator for personal and nefarious purposes.

This inequity has not gone unnoticed. As early as the 1898 peace negotiations after the Spanish-American War, the U.S. government contended that neither the United States nor Cuba should be held responsible for debt incurred by Cuba's colonial rulers without the consent of its people and without regard for their benefit. Although Spain never accepted the validity of this argument, the United States prevailed, and Spain took responsibility for the Cuban debt under the Paris peace treaty. The Soviet state repudiated tsarist debt in 1921 using a similar rationale. Legal scholars subsequently elaborated a doctrine of “odious debt,” arguing that sovereign debt should not be transferable to a successor government if it was incurred without the consent of, and without benefiting, the people. Some scholars added the requirement that creditors must have been aware of these conditions when they issued the loans to repressive or looting governments.

Beginning in the late 1990s, a worldwide campaign called Jubilee 2000 attempted to call attention to the concept of odious debt by enlisting spokesmen as diverse as the pop star Bono and Pope John Paul II in a mass mobilization to eradicate Third World debt. But the doctrine of odious debt has gained little momentum in international law, which continues to hold countries responsible for repaying illegitimate debt.

The apartheid regime in South Africa, for example, borrowed from private banks through the 1980s, while a large share of its budget went to finance the military and police and otherwise repress the African majority. Today the South African people bear the debts of their repressors. The Archbishop of Cape Town has campaigned for apartheid-era debt to be declared odious and written off. South Africa's Truth and Reconciliation Commission has voiced a similar opinion. But the post-apartheid government has deferred to the current international norm and accepted responsibility for the debt out of fear that defaulting would hurt its chances of attracting foreign investment. Indeed, its top ministers recently denounced a lawsuit seeking reparations from banks that loaned to the apartheid regime, because “we are talking to those very same companies named in the lawsuits about investing in post-apartheid South Africa.”

Similarly, although Anastasio Somoza was reported to have looted \$100 million–500 million from Nicaragua by the time he was overthrown in 1979, and the Sandinista leader Daniel Ortega told the United Nations General Assembly that his government would repudiate Somoza's debt, the Sandinistas reconsidered when their allies in Cuba advised them that repudiating the debt would unwisely alienate them from Western capitalist countries.



Numerous other dictators have borrowed from abroad, expropriated the funds for personal use, and left the debts to the population they ruled. Under Mobutu Sese Seko, the former Zaire accumulated more than \$12 billion in sovereign debt while Mobutu diverted public funds to his personal accounts (his assets reached \$4 billion in the mid-1980s) and used them to retain power by paying cronies and military expenses. Similarly, when Ferdinand Marcos lost power in 1986, the Philippines owed \$28 billion to foreign creditors, while Marcos's personal wealth was estimated at \$10 billion.

In 1996 the World Bank indicated a willingness to depart from traditional international lending practices by launching the Heavily Indebted Poor Countries initiative, which provides debt relief for poor countries on the basis of the level of a country's debt and its income. The initiative, however, does not take into account the circumstances under which the debt was incurred. As a result, South Africa and the Philippines, for example, are not on the current list of debt-relief candidates despite plausible claims that their debts are illegitimate.

Policies to Curtail Odious Debt

One potential solution to this problem is for the international community to empower an independent institution to assess a regime's legitimacy and to declare any sovereign debt subsequently incurred by an illegitimate regime "odious" and thus not the obligation of successor governments. In this new setting, debtor countries would no longer need to fear that their ability to borrow from abroad or to attract foreign investment would suffer if they refused to repay debts fraudulently incurred in their name. Creditors, both private and public, would curtail loans to regimes identified as odious, knowing that successor governments would have little incentive to repay them. Such a reform would not

only limit the debt burden of poor countries but also reduce risk for creditors and hence lower interest rates for legitimate governments that borrow.

Two enforcement mechanisms could help eliminate lending to odious regimes. First, new laws in creditor countries could make it illegal to seize a country's assets for nonrepayment of odious debt. Odious debt contracts, in other words, could be made legally unenforceable. Second, foreign aid to successor regimes could be made contingent on nonrepayment of odious debt. Donors could refuse to give aid to a country that, in effect, was handing the aid over to banks that have illegitimate claims. If the foreign aid were valuable enough, successor governments would have incentives to repudiate odious loans, so banks would refrain from originating them.

As noted, repudiating odious debt is self-enforcing. Successor governments will have incentives to repudiate odious debt as long as creditors and investors are willing to continue lending to and investing in the country after its legitimate government refuses to repay the odious debt. Banks will think twice before lending to an illegitimate, repressive regime if the world's leading powers, international organizations, and financial institutions declare the regime odious and announce that they will consider legitimate successor governments justified in repudiating any new loans the odious regime incurs.

Because more countries engage in foreign trade than in sovereign borrowing, limits on borrowing could not be applied as widely as trade sanctions. Nonetheless, the move could have a significant impact. Franjo Tudjman of Croatia, for example, was arguably an odious ruler, having suppressed the media, instigated violence against political opponents, and looted public funds. In 1997 the International Monetary Fund cut off aid earmarked for Croatia because the United States, Germany, and Britain were concerned about the "unsatisfactory state of

When Debt Is Not Odious: How to Approach Lending Bailouts

Sometimes, legitimate governments borrow to finance economically disastrous policies, necessitating later repayment of loans that have accomplished nothing. These cases too raise questions about loan repayment. If a country's electorate chooses a government that borrows to implement bad policies, some would argue that it is their prerogative and that blocking the government's ability to borrow would be a breach of

international sovereignty. But others contend that the international financial institutions (IFIs), such as the World Bank and the IMF, should not have to subsidize wasteful spending, though they sometimes do so in the form of aid to countries whose economies have collapsed. This is the familiar moral-hazard argument: the expectation of bailouts from IFIs encourages commercial banks and bondholders to make loans that governments

could not reasonably repay on their own.

The IFIs could discourage such opportunistic lending by private creditors by assessing the creditworthiness of governments themselves on purely economic grounds. They could announce that, in their view, the policy a government is pursuing is likely to make it unable to fulfill its debt obligations. The IFIs could also announce that they will be willing to provide aid to the country once it resumes sound policies, but not to help repay debt issued after the announcement. In particular, a condition of

future assistance would be that countries not be simultaneously repaying loans made after the IFI announcement. In this way, the IFIs would avoid encouraging private lending to the country motivated by anticipation of a bailout. Unlike odious debt, loans would not be considered illegitimate and unenforceable. If creditors thought the country could repay without an IFI bailout, they would continue to lend. This approach would also enable the IFIs to continue giving aid to countries that followed good policies but suffered bad luck.

democracy in Croatia.” Commercial banks nevertheless lent an additional \$2 billion to the Croatian government between the IMF decision and Tudjman’s death in December 1999. Had the loan-embargo system been in place, creditors might not have granted Tudjman that \$2 billion in loans, and the Croatian people would not bear the debt today.

Incentives for Truthfulness

One reason for the international legal community’s reluctance to accept the doctrine of odious debt is the fear that debt will be declared odious after a loan has already been made, making it impossible for a creditor to be repaid. If creditors anticipate being unable to collect on even legitimate loans, they will be wary of lending at all, raising the possibility that the debt market will shut down. To overcome the risk that creditors’ loans might be declared odious after the fact, the newly empowered institution could be authorized to rule only on future loans to a government and not on existing debt.

Another concern about the doctrine of odious debt is that an institution charged with assessing the legitimacy of debt might be more mindful of the welfare of the people of developing countries than of that of banks and other creditors. But if the institution rules only on future loans, it will be more likely to make accurate, impartial judgments. Even if it weighs more heavily the welfare of debtors than that of creditors, it would have every reason to judge a regime impartially because an accurate judgment would benefit the population. If the institution wrongly calls a legitimate government odious, it deprives a country of profitable investments financed by loans. If it wrongly calls an odious government legitimate, the repressive government can borrow and loot the country.

Requiring the institution to rule on the legitimacy of loans only before they are incurred limits the potential for favoritism in yet another way. Before a loan is issued, it offers only small expected profits for banks, which have many alternative uses for their capital. Once a loan has been made, however, outstanding debt is a zero-sum game between creditors and debtors. A biased institution can help whichever party it favors in deciding whether the loan should be repaid. False rulings about debt that is yet to be issued can hurt the people in borrowing countries and cannot substantially help creditors. Thus, an institution empowered to rule only on future lending is unlikely to make biased judgments in favor of either.

Still another possibility for institutional bias involves a lack of evenhandedness toward certain governments. If the major powers regard a country as an important trade partner or a strategic ally, the institution might fail to brand the government odious regardless of misdeeds. It would, for instance, be unlikely to label either China or Saudi Arabia odious. Because such regimes with powerful friends can borrow at present, biased decisions in their favor would not be a change for the worse; they would simply maintain the status quo. But what if instead the institution makes a judgment against a government for foreign policy reasons, cutting that government off

from lending even though it has the consent of the people or spends for their benefit? For example, the United States might wish to block loans to the current government of Iran regardless of whether the government satisfies the definition of odiousness. If the Iranian government were to be blocked from borrowing money that would have been spent for the benefit of its citizens, the citizens would be worse off than under the status quo. Requiring unanimity or at least a two-thirds vote to declare a regime odious could safeguard against that possibility.

Who Should Assess Regimes?

A key question for the international community is which institution to empower to rule on odiousness. The United Nations Security Council, which already imposes sanctions against governments, is a natural candidate. The United States and the other permanent members of the council might prefer this option, for it would give them a veto power. Another option is to create a new international judicial body to hear cases brought against particular regimes—a court similar to the newly established International Criminal Court in the Hague.

Major creditor countries could also implement this system using solely domestic institutions. If the United States changed its laws to prevent seizure of the assets of a foreign government that repudiated odious debt, if a U.S. court ruled that a regime was odious, and if the U.S. government announced it would oppose IMF or World Bank aid packages to a successor regime that repaid illegitimate debt, then banks (both in the United States and abroad), other governments, and even the international financial institutions would likely be reluctant to lend to that regime, fearing that successor governments would not repay.

It might also be possible for civil society to begin putting pressure on banks not to lend to illegitimate governments. If a highly respected nongovernmental organization like Transparency International—or a panel including prominent citizens like Nelson Mandela, along with international lawyers and human rights scholars—were to identify odious regimes and promulgate a list of them, creditors might be reluctant to lend to governments on the list.

Looking Ahead

If the international community were to empower a global institution to rule that a country is not responsible for odious debt issued after the ruling—and if creditors were therefore to refuse to issue odious debt—both legitimate debtors and their creditors could benefit. All creditors would gain from knowing the ground rules. If odiousness were declared in advance, banks would avoid lending to odious regimes and would have no fear that a successful popular debt-relief campaign would arise to nullify their outstanding loans. Greater certainty would also ensure lower interest rates for legitimate borrowers. Most important, dictators would no longer be able to borrow, loot the proceeds—or use them to finance repression—and leave the debt for their ill-treated citizens to repay. ■

ECONOMIC CRISIS

SOME EVIDENCE FROM THE ECONOMICS OF HAPPINESS

s crisis after crisis has swept through Latin America, optimism about the region's turn to the market and democratic government during the mid-1990s has given way to grave concern.

Most of the economic and political news lately has been disheartening—Argentina's economic collapse and subsequent default on its debt, threats of defaults in Uruguay and Brazil, strikes and stagnation in Venezuela, and often violent protests against tough economic measures in Ecuador and Bolivia. Even Chile, supposedly Latin America's "tiger," is slated to grow only 2.5 percent in 2003, with unemployment at 9.5 percent—higher than it has been in two decades. Longstanding social and economic ills—the world's highest inequality rates, along with high incidences of poverty, violence, crime, and corruption—continue to plague the region.

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Por la
Democracia
y la Libertad
¡Párat



How will the financial crises affect a region already suffering from reform fatigue? Will declining public backing for market policies translate into support for radical alternatives? Will frustration erode individuals' faith in future progress, for themselves and their children? Will diminished individual well-being lead to increased social and political unrest? We attempt to shed light on these questions based on an analysis of the *Latinobarometro*, a regionwide public opinion survey that explores respondents' perceptions and other measures of well-being broader than simple income criteria.

Happiness and Economics

Although research on happiness has traditionally been the realm of psychologists, economists have recently begun to analyze subjective well-being and its relation to objective economic conditions and individual economic behavior.

Building on early work by Richard Easterlin, economists' findings have underlined the importance of nonincome determinants of well-being, such as health, marital status, and job security and satisfaction, as well as the role of relative income differences and economic insecurity.

Considering these results often leads to assessments of welfare that depart sharply from conventional assessments—and have quite different implications for policy.

Economic Crisis and Happiness in Latin America

The crises in Latin America in the past year may well have affected subjective well-being in the region, in turn affecting public attitudes about markets and democracy in the region. We explore the relationship between subjective well-being and public support for market policies and democracy in 17 countries in Latin America, with approximately 1,000 respondents in each country.

As a simple exercise (and accepting the methodological problems of comparing happiness levels across samples and years), we compared mean happiness scores on the *Latinobarometro* in 2002 and 2001. The share of respondents describing themselves as "very" or "fairly" happy fell from 68.2 percent in 2001 to 65.4 percent in 2002; the share describing themselves as "not at all" or "not very" happy rose from 31.8 percent in 2001 to 34.7 percent in 2002, differences that are statistically significant.

These declines in happiness may well be temporary, and substantial evidence suggests that most people eventually adapt to what psychologists call homeostasis, or a "normal" (for each individual) level of happiness, even after major negative life-

AP/WIDE WORLD PHOTO

changing events—though how and how quickly individuals' subjective well-being recovers to "normal" after national crises is uncertain.

Still, the decreases in happiness in the region are likely to have some negative spillover effects. Research in Latin America by one of the authors (Graham) and Stefano Pettinato, for example, finds that happier people are, on average, more supportive of both markets and democracy. While it is difficult to establish the direction of causality in this link, decreases in happiness in the region could jeopardize a virtuous circle.

In addition, deeper analysis of regional happiness evinces cause for concern. Research in the United States, Russia, and Latin America has documented that in general, people grow less happy as they grow older, until at about age 45–50 (depending on the country) their happiness levels start increasing. Our calculations for Latin America in 2002 show a sharp increase in this age-inflection point to more than 60, a reflection, perhaps, of heightened anxiety among people approaching retirement age.

Can Market Policies Be Sustained?

Much has been written in the popular press in recent months about the potential backlash against market policies and reforms. Ignacio da Silva (Lula), the newly elected president of Brazil, the region's largest economy, is a former union leader known for his strong anti-market platform. Protests against privatization brought down a star-studded cabinet in Peru in July 2002. Demonstrations against water privatization paralyzed economic activity for days in Ecuador, Bolivia, and Argentina soon thereafter. The political landscape in troubled Argentina, once a bastion of support for the region's free-market reforms, is at best unknown.

Are Latin Americans turning away from the market? That is certainly a plausible interpretation of the above events. Another, however, is that most Latin Americans accept basic market principles but increasingly also want governments that can provide decent social services and social insurance. For example, all the presidential candidates

in Brazil, including Lula, tempered their antimarket rhetoric as the election approached. Although they might have modulated their rhetoric to calm jittery financial markets and ensure the sustainability of the \$30 billion bailout granted by the International Monetary Fund earlier in 2002, they may also have recognized that being antimarket alone is not an effective message. Similarly, the front-runner in the November 2002 Ecuadorian elections, Lucio Gutierrez, a candidate known for his antimarket stance, went to great pains to convince the financial markets that he was neither a populist nor an ideologue.

Eroding Support, Increasing Anxiety

According to the Latinobarometro, market policies have indeed lost support in the region, particularly among the wealthier respondents who were once their strongest backers. Yet a close look suggests that our alternative interpretation is also at play: respondents support markets and democracy in theory but are more critical of how they are working in their own country.

The simplest story is that support for privatization—never great—has dropped. In 2000, 38 percent of survey respondents agreed that privatization had been beneficial for their country; in 2002, that figure fell to 32 percent.

Worries about unemployment are on the rise. The share of poll respondents who were very concerned about losing their job rose from 46 percent in 2000 to 58 percent in 2002, while the share who were not at all concerned fell from 13 percent to 9 percent. Women tended to be more fearful of losing their jobs in 2002 than were men, as were younger and less wealthy respondents, private employees, and those who did not have high expectations for their children.

A More Complex Picture

Support for other market reforms offers a more complex picture. Most respondents back specific market policies, such as trade and the role of the private sector. Using an index that reflects respondents' pro-market attitudes, we find Latin Americans in 2002 to be as supportive of market reforms as they were in 2000

and 2001, with this support being strongly and significantly linked to wealth and education. More educated Latin Americans are less likely to be *satisfied* with the way the market works, yet more likely to be supportive of specific market policies.

In 2002, respondents at the higher end of the income scale, as expected, offered stronger support for market policies such as free trade, the private sector, and privatization. Yet a more subjective question—whether respondents were satisfied with how the market economy works in their country—did not elicit the expected linear relationship with wealth. Simply put, only the very wealthiest are satisfied with how the market is working.

That satisfaction with market policies has declined among middle-income respondents is in keeping with earlier research on the effects of market policies on the middle class. Market reforms tend to help people at the top of the income distribution by liberalizing trade and capital flows and those at the bottom by stabilizing inflation, but offer those in the middle a much more mixed experience. College-educated and private-sector employees tend to fare better; less educated and public-sector workers, worse.

Before Latin America's turn to the market, a secondary education guaranteed a stable and relatively "privileged" middle-class lifestyle—often with a job in the public sector. Today public-sector jobs are fewer and less desirable. Rewards now go to highly skilled workers, who are in short supply. Not surprisingly, public-sector workers are less likely than other respondents to support market policies.

As expected, respondents who are optimistic about their future prospects are much more likely to be pro-market than other respondents. They also tend to be wealthier and more educated than average, to place themselves to the right on a left-right political scale, and to believe that the distribution of income in their country is fair. Respondents who are optimistic about their children's prospects also tend to be wealthier and more politically conservative than aver-

Most Latin Americans accept basic market principles but increasingly also want governments that can provide decent social services and social insurance.

age, as well as more likely to be satisfied with how the market is working. They are also more likely to be optimistic about their country's future economic situation, even if they are not satisfied with its current situation, most likely reflecting hope, optimism, and other behavioral traits.

Changing Attitudes among the Wealthy

A Latinobarometro question asking if taxes should be lowered even if welfare and other state services suffer elicits another story. Surprisingly, respondents willing to give up state services for lower taxes do not tend to be wealthy or highly educated. They do, however, tend to be private employees and on the right on the political scale. They also tend to be optimistic about their future prospects—though, interestingly, not necessarily about their children's. One interpretation of this finding is that when people think in terms of their own income, they want lower taxes, but as they think about their children's future, they may be more concerned with the public services that taxes provide. Interestingly, those who favor lower taxes have, on average, a higher fear of unemployment.

These findings too suggest that wealthier, more educated, and presumably more secure people seem to be attributing higher value to the role of government and social welfare spending than they once did, while those in a more precarious situation do not seem to have faith in the government's ability to do anything about it—a logical expectation given the current state of government social insurance in much of the region.

What do respondents think about the fairness of income distribution in 2002? Only 13 percent think it is fair or very fair. In a remarkable departure from the past, respondents who take that position are not wealthier, on average. Nor do they tend to be well educated. Unsurprisingly, those who find the current

income distribution fair tend to believe taxes should be lower regardless of the trade-off, and have higher expectations for their children's future.

Support for free trade comes from wealthier, more educated people and from skilled workers, who have benefited more than unskilled workers from the opening to free trade and freer capital flows. Rather surprisingly, unemployed respondents tend to favor free trade, presumably because they think it will increase job opportunities—a view that the jobless in the advanced industrial economies are unlikely to share. Respondents who are strongly pro-market, who favor lower taxes, and who place themselves on the right of the political spectrum also tend to favor free trade. Those who think the distribution of income is fair are less likely to favor free trade.

In sum, support for market policies in the region has changed over the past several years. Support among middle-income respondents has declined. Support for privatization has fallen, and fear of unemployment has grown. A positive trend, however, is that wealthier respondents may be recognizing the importance of the role of government and welfare policies. The shift may be a result of self-interest rather than enlightenment, particularly given the regressive nature of public spending in the region, but it is still a first step, one that may provide a basis for crafting the sustainable and domestically financed social contracts that the region has long sorely needed.

Implications for Governance

Surprisingly, the share of Latin Americans who favor democracy over any other system of government is growing despite deteriorating economic conditions. Although it fell from 64 percent in 2000 to 55 percent in 2001, it rebounded in 2002 to 64 percent. The share of those who would accept an authoritarian government “under certain circumstances” has also fallen—from 22 percent in 2001 to 17 percent

in 2002. The overall trends since 1996, when the survey began, have been slightly negative, which is not surprising because expectations for both reform and the democratic transition were still high at that point, and overall economic performance since has been poor.

Trends vary by country. Remarkably, given the severity of the crisis in Argentina, more Argentines prefer democracy this year than last—a large vote of confidence for democracy under extraordinarily difficult economic circumstances. In some countries, such as Brazil and Colombia, trends are less positive.

One positive trend is that Latin Americans seem to be moving in the direction of the advanced industrial democracies in terms of distinguishing between the poor performance of governments and the system of governance. Although generally supportive of democratic government, they are much more critical of the performance of their own governments—and political parties—in terms of issues like corruption. We find a marked difference, as we have in the past, between the determinants of respondents' satisfaction with the way democracy is working and those of their preference for democracy over any other system.

Respondents who prefer democracy tend to be well educated, but not necessarily wealthy (though wealthier people tended to prefer democracy in 2000). Students also tend to express a preference for democracy, as do those who have positive expectations for themselves and their children. The preference for democracy by the latter suggests a virtuous circle that could be strengthened by effective public policy in areas such as education. Less encouraging is that in 2002, those who favor pro-market policies tend not to prefer democracy.

Happier people were also more likely to prefer democracy in 2002. In 2000, by contrast, there was no significant link between happiness and preference for democracy. Happiness was linked with

Surprisingly, the share of Latin Americans who favor democracy over any other system of government is growing despite deteriorating economic conditions.

satisfaction with how democracy works in 2000, though the direction of causality is not clear. Happier people may assess whatever system of government they happen to live in more positively than less happy people.

The portrait of those who are satisfied with how democracy works is changing. In sharp contrast to 2000, when the more well-to-do were strongly and consistently satisfied with democracy in practice, today the wealthy and middle class are more critical. More educated people also tend to be critical, as they have been in the past. Self-employed and unemployed people do not tend to be satisfied with democracy in practice. Those who approve democracy's workings tend to favor market policies, are happier, trust others, and have high expectations for their own and their children's future.

Corruption Remains Major Issue

Corruption features strongly in respondents' criticisms of both democracy and the market. Those who have been a victim of corruption tend not to be satisfied with democracy, though their experience does not affect—interestingly—their preference for it over all other systems. Those who have known an act of corruption are also much less favorably inclined to the market.

In general, poll respondents think corruption is a big problem. A large majority in all countries (the most in Argentina) think that corruption is becoming ever more serious. Men, as well as wealthier and more educated people, are most likely to have witnessed a corrupt act. People with high expectations for their own and their children's future were less likely. Women, on the other hand, were more likely than men to believe that corruption had increased, as were those who believed that taxes should be low regardless of the trade-offs. Those with high expectations for their children's future, those who trusted others, happier people, and those to the right on the political spectrum were

more likely to believe that corruption had fallen.

Political activism, according to the 2002 poll, tends to enlist younger people, as expected, as well as more educated and more left-leaning respondents (but not those who regard the distribution of income as unfair) and those who have experienced an act of corruption. Respondents' wealth and their propensity to political activism were not linked—surprisingly, given the common assumption that deprived people are likely to be dissatisfied with their situation and therefore more willing to protest. One explanation is that attitudes among the wealthy are changing. Another is that upwardly mobile respondents in the middle and lower middle class are more likely to express dissatisfaction than are the poor, partly because they are more likely to know how the very wealthy live and to be more concerned about relative income differences, partly because the poor tend to have less free time to participate in politics. Political activism does not attract happier people, those with high expectations for themselves and their children, or those who prefer democracy to any other system.

What Lies Ahead?

Contrary to the myriad predictions of a looming backlash against reform, our findings suggest cautious optimism. Subjective well-being in the region has indeed declined, particularly in the crisis countries. Given the strong links between positive well-being and support for markets and democracy, the decline is cause for some concern. That said, most respondents distinguished clearly between the performance of particular governments and that of democracy as a system of government, with support for democracy actually increasing. Similarly, respondents distinguished between market policies and the way the market is working.

On the other hand, support for market policies in the region declined, espe-

cially among middle-income respondents, as did support for privatization. Corruption features strongly in respondents' criticisms of democracy and the market, and those who had witnessed a corrupt act seemed more inclined toward political activism.

Despite our appeal for guarded optimism, these developments are real causes for concern. Middle-class frustrations, along with the entrenched corruption and inequality that are widespread in the region, have the potential to cause unrest. The middle classes find themselves more vulnerable after market reform, and the poor see very slow returns. Adding to the reform animosity is the perception that the region's already high inequality is being exacerbated as those with human and financial capital see greater returns to their assets.

Recent events demonstrate the loss of public patience. In Bolivia an unexpected popular uprising against the reform-minded government of President Sanchez de Lozada led to the resignation of his entire cabinet. Strikes and protests against privatization and adjustment programs in El Salvador, Nicaragua, and Ecuador have turned violent.

It is a critical moment for U.S. policymakers to work to sustain Latin Americans' faith in markets and democracy by following through on important policy commitments, such as to the international financial institutions, to free trade and opening its markets to Latin American producers, and to foreign assistance commitments in the case of the poorest countries. The U.S. administration must also remain a strong proponent of democratic government in the region. Its initial support for the April 2002 coup against Venezuelan President Hugo Chavez, for example, eroded its credibility in the region, hence weakening its influence in resolving the current crisis there. The administration needs to recognize this and support, not intervene in, the region's fragile democracies. ■

By Lael Brainard

THE MILLENNIUM CHALLENGE ACCOUNT AND FOREIGN ASSISTANCE

Transformation or More Confusion?

On March 22, 2002, President Bush announced a plan to increase U.S. bilateral development aid starting in 2004, reaching an added \$5 billion a year by 2006. The full increase in funding—nearly twice the size of existing U.S. bilateral development assistance programs—would set up a Millennium Challenge Account (MCA) to promote growth in reform-oriented developing countries. Nations receiving the aid would have to meet eligibility criteria involving good government, economic freedom, and investment in health and education.

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The MCA presents an enticing opportunity to transform U.S. development policy toward the world's poorest countries. With allocations based solely on economic performance and governance, the MCA would be the closest to a development purist's blueprint for aid that the United States has ever attempted. Its clear criteria and substantial sums of money offered on enticing terms could create incentives for governments to improve economic policies and governance while helping strong performers sustain growth and improve investment climates. It could also force greater clarity of roles and missions among the many U.S. programs for developing nations. But the proposal is not without risk. The administration must take care not to add to the confusion of overlapping U.S. foreign assistance agencies. It must offer a clear-eyed vision of how the MCA fits alongside existing U.S. programs for developing nations, especially the Agency for International Development (AID), the 7,000-strong agency established in 1961 to promote "sustainable development." It must also squarely address the tension between foreign policy and development goals that chronically afflicts U.S. foreign assistance.

Serving Two Masters

The tension between development and foreign policy is particularly acute because the MCA is being crafted at a time when national security has returned to the nation's consciousness to an extent not seen since the Cold War. Indeed, the MCA was announced in the context of the war against terrorism, just months after the tragedy of September 11. President Bush explicitly cited the antiterrorism rationale in announcing the MCA: "We fight against poverty because hope is an answer to terror."

More often than not, U.S. foreign assistance programs have failed because development and foreign policy objectives have pulled in different directions. It makes little sense to expect aid dollars that are allocated according to geopolitical criteria to promote growth and development. Aid allocated according to the logic of the Cold War has often been lost to corruption, waste, or diversion—as in Zaire, Liberia, Sudan, and Somalia. Billions were poured into Egypt after the Camp David peace accords without producing durable economic or political modernization.

It is important to distinguish between the principles guiding the allocation of aid among countries and the purposes on which aid is spent. Strictly speaking, for assistance to have the greatest development impact it must not only be spent on economic development but also be allocated on the basis of development worthiness. Most of what is considered "economic assistance" in the U.S. budget goes to countries based on political considerations, even though the money itself is used for economic purposes. Only about a third of U.S. bilateral economic assistance is now allocated among countries based on development priority—and of that, much is based not on performance but on assessed needs as well as U.S. political and economic objectives. In principle, pure development assistance should be allocated to the investments with the highest marginal value, determined by the extent of need (or

the marginal social value) and the recipient country's policy environment. The Millennium Challenge Account would try to isolate the highest potential investments by targeting only the best-performing poor countries.

The theory animating the MCA appears akin to a takeoff model, where foreign assistance plays a catalytic role at a critical stage, helping a country with good policies to attract investment and trade that enable it to graduate from the program rather quickly. Most development experts expect this process to take decades, rather than a few years. Nonetheless, many outside observers support the emphasis on strong policy environments and hope the focus on the best performers will win political support over time.

Critical Design Elements

As of the end of 2002, the Bush administration had developed details on some but by no means all elements of the MCA's design. The Millennium Challenge Corporation will be a new government entity overseen by a board composed of cabinet officials and chaired by the secretary of state. It will have a staff of roughly 100 on limited-term appointments.

In the first two years only countries with per capita incomes below \$1,435, the internationally recognized income threshold for "low-income" countries, will be allowed to apply. In the third year the pool will expand to include countries with incomes up to \$2,975—the World Bank cutoff for lower-middle-income countries. The enlarged pool, which brings such strategically significant countries as Jordan, Egypt, and South Africa into the tent, could give MCA decisionmaking a political tilt.

Selection of recipients will be based on scores on 16 data indicators grouped in three broad areas: governing justly, investing in people, and economic performance. A country must score above the median on half of the indicators in each area to qualify—and must also score above the median on controlling corruption. Although the approach is as objective as one is likely to find in the realm of policy, in practice it can produce some surprising outcomes. A dry run undertaken by Steve Radelet, for example, finds that both China and Egypt would qualify for MCA aid despite China's severe human rights deficiencies and Egypt's history of wasted aid. Such anomalies will leave a big role for subjective judgment, which could also lead toward greater geopolitical bias, especially given the administration's decisions to make the secretary of state head of the board of directors and to include wealthier—and more politically salient—countries in the third year. The emphasis placed by the MCA on virtue relative to need is starkly evident in that eligible countries are home to only 12.8 percent of the population of sub-Saharan Africa, the poorest region of the world.

The types of programs eligible for MCA aid still await definition. When first announcing the MCA, President Bush offered only broad-brush guidance about the programs it would fund: basic health, education, and poverty alleviation. Support for all these programs is broad not only in the administration and Congress but internationally. Although environ-

Financing for Development



mental and energy programs have garnered support at the international level and among some members of Congress, they do not appear to have many advocates within the administration, which has emphasized an interest in private-sector development and infrastructure investment—although AID has long since exited that troubled field.

Finally, the MCA proposal rests heavily on country ownership and accountability. In accord with a growing international consensus that development investments perform better the more they are formulated by the beneficiary government in the context of integrated development strategies, governments that meet the selection criteria would submit funding proposals of their own choosing, rather than be guided by U.S. consultants. The projects, once begun, would be rigorously monitored. Specialists familiar with the messy realities of development projects worry, however, about the limited capacity of poor-country governments to design and implement acceptable grant proposals. They also wonder whether an agency with a staff of 100 can effectively administer and monitor \$5 billion in grants each year. The implied level of assistance disbursed per staff member is \$50 million, more than 10 times the per-staff level typically disbursed by bilateral aid agencies.

What about AID?

Every administration for the past 30 years has tried to reform AID. The Bush administration has instead decided to design around it. Although development experts advocated creating the Millennium Challenge Corporation as an autonomous entity within AID, the administration established it as an inde-

pendent corporation overseen by the State Department.

Far from rendering AID irrelevant, the decision to make the MCC an independent corporation has placed AID squarely in the spotlight. If the proposal is to transform U.S. development policy, it must articulate a clear division of labor among the MCC, AID, and other programs for developing nations.

The MCC would likely operate initially in countries that now account for one quarter of the economic assistance administered by AID. One could imagine a variety of scenarios regarding MCC and AID coordination within these countries. At one end of the spectrum, MCC qualification could mean that AID would pack its bags and move elsewhere. Or MCC could fund the top priorities of the local government, while AID maintained programs in areas of high priority to the United States, such as child survival and health and HIV/AIDs. Or responsibilities could be divided according to the different budget authorities of the two agencies, with AID limited to nonrecurring expenses such as teacher training and technical assistance, while the MCA specialized in capital expenditures, such as school buildings, and recurring costs, such as teacher salaries. Or over time, AID might continue to focus on social sectors, while the MCA became more focused on the private sector.

But most of these divisions entail problems that tend to blur the sharp identification of the MCA with the best performers. And from a practical standpoint, the administration has not yet determined what would happen to AID mission staff in those countries where the MCA was likely to operate. Certainly, it would be wasteful to duplicate staff. But if AID

staff assisted with the preparatory work and contracting and helped monitor and evaluate MCC programs, it would suggest a troubling misalignment of AID staff incentives and responsibilities and heavy MCC dependence on AID.

For near-miss countries that failed to qualify for the MCA by virtue of one or two indicators, it is not yet clear which agency would take lead responsibility. This question is important because it is in precisely such countries that the promise of vastly increased foreign assistance could be catalytic in strengthening the policy environment. For near-miss countries, limited funding to address weak areas could be made available through the MCA but managed through AID on the presumption that greater oversight and involvement would be entailed than for normal MCA grants.

Even the clearest structure, where the MCA operates in high-capacity countries and AID in low-capacity countries, has some anomalous implications. If AID is left with three core missions—humanitarian assistance, transition assistance for post-conflict countries, and social assistance in poorly performing states—more of its programs will be directly related to foreign policy than ever before. And in principle, the MCA's mission should be relatively free of foreign policy considerations. Yet the administration's proposal would give the State Department the lead role on the board overseeing the MCA, while doing nothing to strengthen State's input into AID decisionmaking.

Important questions also involve coordination among U.S. development programs more generally. Most obviously, the more the MCA moves in the direction of funding infrastructure and enterprise funds, the more it raises questions about overlap with the Overseas Private Investment Corporation, the Export-Import Bank, and the Trade and Development Agency. And U.S. development assistance will not achieve maximal efficiency and impact unless it is part of a coherent approach across all U.S. development programs, such as debt relief, trade preferences, and the credit-rating process. Creating another independent agency with its own idiosyncratic conditions threatens to add to the confusion. A strong mechanism to force interagency coherence would bring greater clarity, as would moving toward a single hierarchy of eligibility criteria over time, so that the best-performing poor nations would automatically qualify for the most flexible terms on trade access, debt treatment, development assistance, and export and investment programs. Unfortunately, the obstacles are high, including jurisdiction problems across agencies within the executive branch and across committees in the legislative branch.

Congressional Oversight

For the MCA to succeed, Congress must be a committed partner. But the MCA will win the necessary trust of Congress only if its design contains adequate self-executing safeguards.

Many of AID's inefficiencies stem from its interpretation of requirements imposed by Congress in the budget process. AID shoulders a heavy burden of congressional earmarks—requirements setting aside specific portions of its budget for purposes such as child survival and health programs. It is also subject to

numerous policy directives—274 at last count. Asked for the single best way to improve their performance, most AID employees would opt for “notwithstanding authority”—the kind of flexibility that allows the Office of Foreign Disaster Assistance to move money rapidly to newly identified needs. Notwithstanding authority makes it possible to bypass time-consuming contracting requirements and procurement regulations that often seem focused on economic stimulus in the United States, rather than in the beneficiary nation.

But to ask for such congressional self-restraint, the administration must put forward a design that builds in comparable self-restraint—for instance, self-executing safeguards against misuse of funds. The combination of transparent, rigorous selection criteria, limiting eligibility to the best performers, and strong accountability through continuous monitoring and periodic evaluations moves in this direction, but may not be enough.

It may also be hard to craft such a procedural deal because congressional oversight on foreign assistance is highly unpredictable. Although most congressional programs are reauthorized every one to five years, the mammoth Foreign Assistance Act of 1961 has not been reauthorized since 1986. The handful of new assistance programs authorized since then has come through piecemeal legislation; attempts at more systematic overhaul have failed. The problems with congressional oversight have numerous explanations, including the perception that foreign aid votes never win favors for members of Congress. Deep ideological differences also exist between key members on the foreign relations oversight committees. Because appropriations bills must be voted each year, much of the oversight normally assumed by the congressional authorizing committees has instead fallen to the appropriators, contributing to the proliferation of funding restrictions.

The administration would have the best chances of winning greater flexibility for the MCA by showing appropriate deference to the authorizing committees. Settling for a piecemeal approach would help the MCA's chance of passage, even though amending the Foreign Assistance Act itself would better clarify the complementary mission of AID.

Promise and Pitfalls

The proposed creation of a \$5 billion annual fund to promote growth in reform-oriented developing countries holds tremendous promise, but the pitfalls—not least the deteriorating U.S. budget outlook—abound. The task of winning Congress's approval of MCA funding is itself sobering. And if the administration gets past that hurdle, others remain. If the selection process is overlaid with a geopolitical screen, if the MCA adds to the confusion surrounding AID's mission, or if the MCA design does not contain adequate self-executing safeguards, the MCA will fall short. And the negative repercussions could be great. A failed MCC would quickly become yet another example of wasted aid, and the most expensive, and could undermine political support for foreign assistance for decades to come. With this in mind, it is extremely important to get it right the first time. ■



INFORMATION Technology & Development

BEYOND “EITHER/OR”

By James Steinberg

After years of drift and inattention to the problems of global development, during the past half decade the international community has dramatically increased its focus on strategies to help the people of the world's poorest countries share in the benefits of globalization and escape the traps of poverty, disease, and lack of education. The decision of the world's leaders at the United Nations Millennium Summit in September 2000 to adopt eight specific development goals provided an agreed political benchmark for measuring progress. Left open, however, were crucial issues about how best to achieve those goals.

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A key unanswered question is the potential contribution that information and communication technology (ICT) can make to this effort. The question is not new. In 1984 the Commission for Worldwide Telecommunication Development (the Maitland Commission) issued an influential report, *The Missing Link*, citing the lack of telephone infrastructure in developing countries as a barrier to economic growth. The advent of the global information technology revolution in the 1990s set off a heated, sometimes acrimonious debate among development specialists and policymakers about the place of ICT in development.

On the one hand are those who see wiring the global South as a way to transcend decades of painful economic development and catapult even the poorest countries into the information age. As United Nations Secretary-General Kofi Annan observed in his Millennium Report, "New technology offers an unprecedented chance for developing countries to 'leapfrog' earlier stages of development. Everything must be done to maximize their peoples' access to new information networks." Proponents of this view not only stress the potential benefits of ICT but also argue that in an increasingly globalized economy, countries that fail to "get connected" will fall further and further behind.

At the opposite end are those who assert that "you can't eat computers." In the words of Microsoft's Bill Gates, "Let's be serious. Do people have a clear view of what it means to live

LDCs had grown (from 12:1 to 17:1). For the Internet, the gap remains significant, although bright spots exist. China, for example, saw a 75 percent increase in Internet users, to 59 million, from 2001 to 2002, making it the second-largest Internet-using country in the world (in addition to being the largest mobile telephone market). Africa now has 5 million Internet subscribers. Moreover, according to the *IMF World Outlook, 2001*, "The rate of diffusion of IT to developing countries has been rapid compared to earlier all-purpose technologies" such as railroads. But today, says the International Telecommunications Union's *World Telecommunications Report 2002*, "[T]he 400,000 citizens of Luxembourg between them share more international bandwidth than Africa's 760 million citizens." In October 2000, 95.6 percent of all Internet hosts were in the industrialized countries; Africa had only 0.25 percent and its share was falling.

Taking Action

Growing awareness of the digital divide spurred several initiatives by the developed world and the international organizations responsible for development, including the United Nations Development Program (UNDP) and the World Bank. At its July 2000 summit the Group of Eight (G-8) industrial countries created the Digital Opportunity Task (DOT) Force. The DOT Force, composed of representatives of G-8 and developing countries, as well as members of industry and non-

Although supporters have a strong intuitive sense that ICT will drive growth by increasing productivity, the empirical evidence remains mixed.

on \$1 a day? . . . There are things those people need at that level other than technology. . . . About 99 percent of the benefits of having [a PC] come when you've provided reasonable health and literacy to the person who's going to sit down and use it." Investing in ICT for poor countries, they argue, draws precious resources away from more urgent development needs. The lack of critical infrastructure, such as adequate energy grids, and of education keeps citizens of poorer countries from tapping ICT's potential.

Modern ICT began to have an impact in some developing countries even before widespread adoption of the Internet. In Brazil, for example, the computer industry accounted for more than 74,000 jobs and \$4 billion in revenue by 1990. In 1988 India launched a set of policies that fostered a software-development industry whose exports grew to \$5.7 billion by 1999-2000.

But the explosive growth of the Internet in the mid- to late 1990s drew increasing attention to the so-called digital divide. Just how serious is the gap? For telephones, the picture is mixed. In 1991, total telephone penetration (fixed plus mobile) per 100 inhabitants stood at 49.1 for the developed world, 3.3 for emerging economies such as Eastern Europe and China, and only 0.3 in the least developed countries (LDCs). By 2001, the gap between developed (121 per 100) and emerging (18.7) had narrowed considerably (from a ratio of 15:1 to 6:1), but that between emerging countries and

governmental organizations, was asked to make concrete recommendations for fostering policy, regulatory, and network readiness; improving connectivity; increasing access and lowering cost; building human capacity; and encouraging participation in global e-commerce networks. Its report, *Digital Opportunities for All: Meeting the Challenge*, became the basis of the Genoa Action Plan, adopted at the G-8 2001 summit. The focus of the plan was on "mainstreaming" ICT as an essential component of overall development strategies "as a fundamental tool for reducing poverty and for spurring sustainable development."

The private sector also stepped up. In January 2000 the World Economic Forum launched its Global Digital Divide Initiative involving leading ICT, communications, and media executives. Hewlett Packard announced a \$1 billion "World e-inclusion" program to sell, lease, and donate products and services to developing countries. Cisco Systems (in partnership with the ITU) set up Internet training centers for students and ICT and telecommunication professionals in the developing world.

The increasing international attention to the digital divide has moved to the forefront a key policy question—just how significant is the divide for the overall prospects for developing countries, and what role should closing that gap play in overall development strategies?

Four characteristics of ICT make it an attractive element of



that ICT can contribute to economic development is somewhat uncertain.

any strategy to meet development challenges. First, ICT is highly versatile. It can be tailored to meet a variety of diverse challenges and need not be “purpose built.” The same network, server, and peripheral devices (such as PCs or cell phones) can help support distance education and remote health delivery and connect rural communities to global markets. Second, ICT can help transcend barriers of geography. It allows individuals and entities anywhere in the world access to the same information without the time and cost associated with physical transportation, an advantage substantially enhanced by the advent of wireless and satellite communications, and voice-over-Internet protocol long-distance service. Third, it allows users, even in poor and small communities, to harness the benefits of scale and “network effects” (the exponential increase in value that comes with each additional user). Finally, it facilitates the transfer of know-how across the full spectrum of knowledge, allowing developing countries to reap productivity gains and harness state-of-the-art technology.

Several problems have nevertheless impeded the widespread adoption of ICT in the developing world and led to some deep disillusionment. Images of unused computer screens in rural schools and telecenters attest to good intentions gone awry. Among the reasons for ICT’s failure to deliver on some of its more overheated hype are lack of skilled workers to maintain equipment and train potential users, inadequate infrastructure (such as electricity), poor government

telecommunication policies that have put costs for interconnection out of reach, and lack of applications tailored to meet the unique needs of developing countries (including language barriers).

ICT’s Development Potential

Assessing the potential value of ICT in supporting development requires addressing the three different channels through which it could work: its inherent worth in bringing new ideas to those outside the global mainstream; its part in helping to achieve specific development objectives; and its role in fostering broader economic development.

First, ICT has enormous potential to enrich the lives of people everywhere—regardless of any instrumental role it may play in meeting broader development needs. These technologies can help bring ideas and experience to even the most isolated, opening to them the world outside their village, town, and country—including family members and friends who have moved away. It also allows their experience to be shared with the world at large, at the tap of a keystroke or the touch of a cell phone keypad. The case for including information technology in development strategies would be strong even if it contributed little to explicit development goals. ICT can also empower individuals to participate in the social and political institutions of their community, giving voice to those who have traditionally been excluded.

Second, ICT-based solutions have already proved their value in addressing several specific challenges identified in the UN’s Millennium Development Goals (MDG). Health care

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workers in more than 150 countries, for example, are using Health Net to bring needed expertise and help deliver health services in underserved, often remote communities. Distance learning initiatives, such as those at the University of South Africa, are training a new generation of teachers, who are critical to meeting the MDG's objective of universal primary education by 2015. The contribution of ICT is not confined to Internet-related projects: radio- and telephone-based services, for example, are making real contributions in areas such as training for health workers in Uganda and Kenya.

Third, in the end the key to self-sustaining development is economic growth. Although supporters have a strong intuitive sense that ICT can make a significant contribution to economic growth by increasing productivity, the empirical evidence remains somewhat uncertain. Anecdotal evidence suggests that effective use of ICT does, at least under some circumstances, make a difference. In the first place, it can provide an important source of income. India's software sector attests to as much. And Costa Rica has attracted some 32 foreign electronic firms since 1995, including Intel and its investment of more than \$1 billion. Even more important in the long run, however, ICT can strengthen overall productivity in developing countries by increasing efficiencies and technological competitiveness and by linking local producers to global markets. The experience of Estonia, which sought to overcome its lack of natural resources and outdated manufacturing sector by embracing an all-encompassing strategy of promoting ICT throughout its society and economy is an example of ICT's potential. A recent study analyzing the positive impact of access to telephones on income in rural China has helped further our understanding of the ways in which ICT can contribute to overall development.

Other studies seem to confirm that with the proper "enabling environment," developing countries can increase their rate of adoption of ICTs, a valuable, though not sufficient, condition for accelerating economic growth.

In 2001 a report by the Digital Opportunity Initiative, a collaboration between the Markle Foundation, the UNDP, and Accenture, identified five core elements to a comprehensive approach to create such an enabling environment—infrastructure (the hardware and "pipes," physical and wireless); human capacity (skilled individuals who can maintain, adapt, train, and use the technology); government policies (telecommunication policies that facilitate the adoption of ICT, along with sound governance and trained regulators more generally); content (applications geared to the specific need of developing communities, such as local language and tools for rural agricultural development); and support for enterprise (much of the ultimate gains from employing ICT largely stem from a vibrant private sector, but the public sector too can improve productivity and performance through ICT).

Although getting each element right can make a significant contribution, an integrated strategy offers the best promise for greatest gain. As a result, many developing countries—from Tanzania to Kyrgyzstan—are beginning to adopt "national

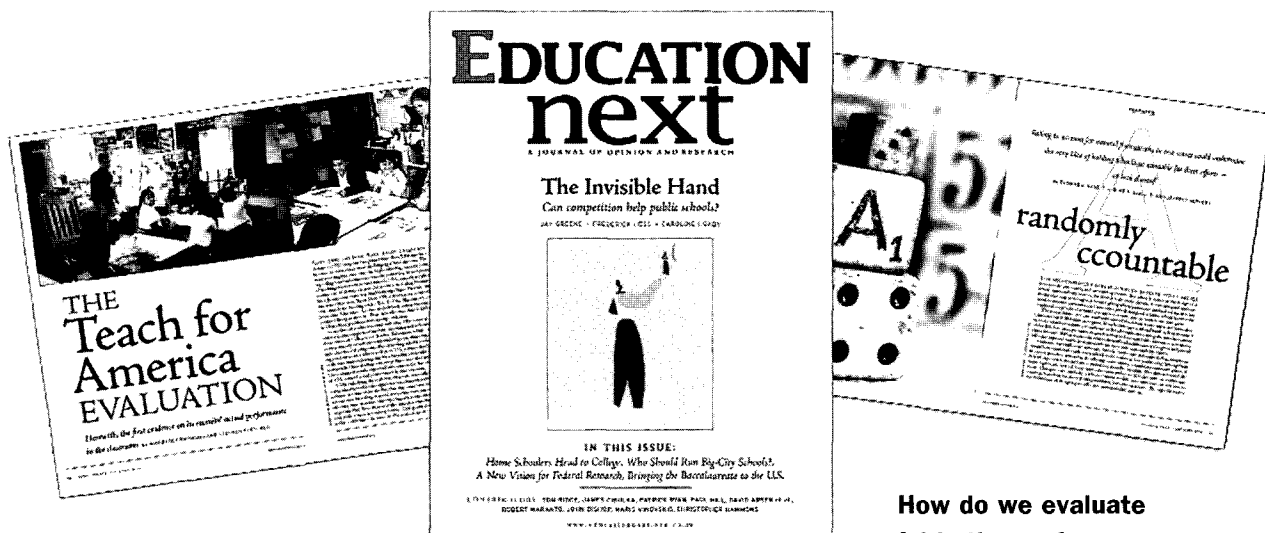
strategies" to address in a comprehensive way these various elements. A key to success is to bring together all the stakeholders—government, the local private sector, and civil society, as well as the donor community—both to develop the plans and to oversee their implementation. Studies suggest that local "ownership" and the involvement of stakeholders is especially critical to successfully harnessing ICTs.

How can the developed world help developing countries make effective use of ICTs? The lesson of the 1990s was that simply providing technology will have marginal impact. This supply-side approach has led to inflated expectations and mistrust that the purveyors of the technology care more about opening markets than helping the poor. Rather, the idea behind mainstreaming ICT into a broader development context is to seek ways to leverage ICTs to achieve core objectives. Sharing expertise (such as training programs for policymakers and regulators in the developing world) and best practices is often more valuable than the hardware itself. Recognizing the limits on the role of official assistance is also critical. Ultimately the broad-scale adoption of ICTs in the developing world will depend on the private sector. But government assistance can play an essential role, both in providing public goods and in helping to create the enabling environment that will encourage private investment.

For developing countries to benefit fully from the ICT revolution, they must have a voice in setting the policies that will affect them—and that voice must be heard not simply in organizations involved in development policy, such as the World Bank and UNDP. On issues ranging from international telephone tariffs to spectrum allocation to property rights, in institutions ranging from ICT-specific groups like the ITU and ICANN (the Internet Corporation for Assigned Names and Numbers), to the multisector World Trade Organization, key decisions are often made with little or no input from the poorest countries. All these institutions will need to take concrete actions ranging from increased transparency, to technical assistance, to training and financial support if these nations are to overcome structural barriers to participation.

Debate on the place of ICT in development has moved beyond the black-and-white arguments of proponents and skeptics in the 1990s. These new technologies, it is now clear, are not an end in themselves. Nor will a one-size-fits-all approach work—the challenges faced by developing countries vary too greatly by history, geography, and level of economic attainment. In particular, the challenges facing larger countries and economies (even where the overall level of poverty is high) differ considerably from those facing smaller nations whose internal markets are small and who are thus critically dependent on linkage to markets and knowledge beyond their borders. But evidence is growing that ICT is a potentially powerful tool when used judiciously as a part of an overall development strategy. The challenge, both for developing countries and for the broader international community, is to build on the experience to date to make these tools available to the stakeholders who are best positioned to adapt and apply them to their most pressing needs. ■

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